85-879

No. ———

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

THOMAS INTERNATIONAL LIMITED,
Petitioner

v.

THE UNITED STATES,
Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

1. Whether Treasury Regulations § 1.993-2(d)(2) (the "993 Regulation") is invalid because it is inconsistent with the legislative history, purposes and language of Internal Revenue Code ("Code") Section 993(b)(3), the Code Section it purports to interpret, and because it is inconsistent with the purpose for which it was promulgated.

2. Whether Petitioner, Thomas International Limited, should be treated as having complied with the provisions of the 993 Regulation in every respect for its taxable years ended March 31, 1977 and March 31, 1978, there having been no harm to the Government or violation of the purpose of said regulation, and there having been substantial compliance with the requirements of the regulation.

LIST OF AFFILIATED COMPANIES

Thomas Built Buses, Inc., a North Carolina Corporation, sole shareholder of Thomas International Limited.

Thomas Built Buses International, a Virgin Islands corporation controlled by Thomas Built Buses, Inc.

Carrocerias Ecuatorianas Thomas, S.A., an Ecuadorian corporation controlled by Thomas Built Buses, Inc.

Ricaseneth, an Ecuadorian corporation controlled by Thomas Built Buses, Inc.

Thomas-Built Buses of Canada Limited, a Canadian corporation controlled by Thomas Built Buses, Inc.

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No. ———

THOMAS INTERNATIONAL LIMITED,
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v.

THE UNITED STATES,
Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPORTS OF OPINIONS

The opinion of the United States Claims Court is reported at 6 Cl. Ct. 414 (1984). The opinion of the United States Court of Appeals for the Federal Circuit is reported at 773 F.2d 300 (Fed. Cir. 1985).

JURISDICTION OF COURT

The decision of the Federal Circuit Court of Appeals was entered on September 18, 1985. Jurisdiction to review the decision of the Court of Appeals by writ of certiorari is pursuant to 28 U.S.C. § 1254(1) (1982).

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are reproduced in the Appendix in the following order:

I.R.C. § 992(a)
I.R.C. § 993(a)
I.R.C. § 993(b)
I.R.C. § 993(d)
I.R.C. § 993(f)
I.R.C. § 994
I.R.C. § 995(a)
I.R.C. § 995(b)(1)
I.R.C. § 996(a)(1)
I.R.C. § 6072
I.R.C. § 7805(a)
I.R.C. § 7805(b)
Treas. Reg. § 1.993-2(a)(3)
Treas. Reg. § 1.993-2(d)
Treas. Reg. § 1.993-4
Treas. Reg. § 1.994-1(e)(3)-(5)

STATEMENT OF THE CASE

This case was originally filed in the United States Claims Court to recover corporate taxes paid by Petitioner with respect to its taxable years ended March 31, 1977 and March 31, 1978. On October 12, 1984, the Claims Court granted Petitioner's Motion for Summary Judgment and ordered a refund of taxes paid, with interest thereon. The Government appealed the decision of the Claims Court to the United States Court of Appeals for the Federal Circuit, which reversed and remanded the case to the Claims Court on September 18, 1985. On October 24, 1985, the Claims Court, pursuant to the mandate of the United States Court of Appeals for the Federal Circuit issued October 17, 1985, allowed the Government's motion for summary judgment, vacated the judgment of the Claims Court entered October 12, 1984, and

directed the clerk to enter judgment dismissing Petitioner's complaint.

Petitioner, Thomas International Limited ("TIL"), is a Connecticut corporation with its principal place of business in High Point, North Carolina. TIL is a wholly-owned subsidiary of Thomas Built Buses, Inc. ("Thomas"), a North Carolina corporation engaged in the business of manufacturing buses for sale in the United States and abroad. TIL was organized to assist in the export activities of Thomas by serving as a domestic international sales corporation ("DISC") under the provisions of Code Section 991 through 997, and has operated as a DISC since its incorporation through December 31, 1984. The issues in this case are relevant to TIL's status as a DISC during its taxable years ended March 31, 1977 and March 31, 1978.

During the years in issue, TIL served as a commission DISC pursuant to a written supplier's agreement of July 1, 1973, executed in conformity with the Code and applicable Treasury Regulations. As a commission DISC, TIL accrued commissions from Thomas on all export sales made by Thomas. The amount of the commission paid to and accrued by TIL with respect to the taxable years at issue was determined under the "50-50 combined taxable income method" described in Code Section 994(a)(2). TIL properly accrued $708,231 in commissions from Thomas for its taxable year ended March 31, 1977 and $329,057 in commissions from Thomas for its taxable year ended March 31, 1978. On its tax returns for the relevant years, TIL reported these commissions receivable from Thomas as qualified export assets under Code Section 992(a)(1)(B).

In a Notice of Deficiency issued to TIL under date of January 9, 1981, the Commissioner of Internal Revenue (the "Commissioner") determined deficiencies in income taxes for fiscal years ending 1977 and 1978 of $453,720. The notice stated that TIL was not qualified as a

DISC for the two taxable years because it allegedly failed to meet the DISC qualification test of Code Section 992(a)(1)(B). Code Section 992(a)(1)(B) requires that the adjusted basis of a DISC's qualified export assets must equal or exceed 95 percent of the sum of the adjusted basis of all assets held by the DISC. The Commissioner asserted that TIL failed to meet this test because trade receivables representing the commissions due TIL from its parent corporation and related supplier, Thomas, were not paid within sixty days of the close of either of the two taxable years in question. The Commissioner cited the 993 Regulation in support of his position.

The 993 Regulation provides that an account receivable representing a commission payable to a DISC with respect to a transaction in which the DISC acted as a commission agent is a trade receivable and is therefore a qualified export asset. If, however, the principal is a related supplier, the 993 Regulation provides that the account receivable representing the commission is not a trade receivable, and, therefore, not a qualified export asset, unless payable and paid in the time and manner specified in Treas. Reg. § 1.994-1(e)(3) or (5). Treas. Reg. § 1.994-1(e)(3)(i) states that the amount of a sales commission (or reasonable estimate thereof) actually charged a related supplier by a DISC must be paid no later than sixty days following the close of the DISC's taxable year. Because TIL did not receive a check representing the commissions due from its related supplier, Thomas, within sixty days of the close of its taxable years ended March 31, 1977 and March 31, 1978, the Commissioner disqualified TIL as a DISC for those years on the basis that it did not satisfy the qualified export asset test of Code Section 992(a)(1)(B).

TIL paid the deficiencies and filed claims for refund. After the Commissioner denied the claims, TIL filed on April 30, 1984 a Motion for Summary Judgment in the

United States Claims Court, asserting that the Treasury Regulation on which the Commissioner had relied was invalid, and alternatively that, if valid, TIL had substantially complied therewith. On cross-motions for summary judgment, the Claims Court held that the 993 Regulation was invalid, granted TIL's Motion, and ordered a refund of all taxes paid by TIL with respect to the taxable years in issue. The opinion of the Claims Court was filed on October 12, 1984 and judgment was entered on that same date.

The Government's notice of appeal was filed on December 11, 1984. The Court of Appeals for the Federal Circuit reversed and remanded the decision of the Claims Court on September 18, 1985. The Federal Circuit determined that the 993 Regulation was valid and that TIL had not substantially complied with the regulation. On October 24, 1985, pursuant to the mandate of the Federal Circuit issued October 17, 1985, the Claims Court issued an order allowing defendant's motion for summary judgment, vacating the Claims Court's judgment entered October 12, 1984, and directing the clerk to enter judgment dismissing TIL's complaint.

REASONS FOR GRANTING THE WRIT

Introduction

This petition for certiorari should be granted because (1) the Federal Circuit's decision conflicts with decisions of this Court concerning the scope of the Treasury's authority in promulgating interpretive regulations and (2) the commissions receivable and substantial compliance issues are important questions of federal law not previously decided by this Court.

I. The Federal Circuit's Decision Conflicts With Certain Decisions Of This Court Concerning The Scope Of The Treasury's Authority In Promulgating Interpretative Regulations Under Code Section 7805(a).

The Federal Circuit's conclusion that the 993 Regulation validly implements the statutory purpose and constitutes a permissible exercise of the Commissioner's broad authority to prescribe needful rules and regulations for the enforcement of the DISC provisions is in conflict with applicable decisions of this Court. Interpretive regulations such as the 993 Regulation are issued under the general authority of Code Section 7805, and are therefore accorded less weight than legislative regulations issued pursuant to a specific congressional delegation of law-making authority. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982); *Rowan Companies, Inc. v. United States*, 452 U.S. 247, 253 (1981). Such regulations are valid only to the extent they harmonize with the language, origins, and purposes of the Code Section they purport to interpret. *See Vogel*, 455 U.S. at 25-26; *Manhattan Gen. Equip. Co. v. Commissioner*, 297 U.S. 129, *reh'g denied*, 297 U.S. 728 (1936).

The Federal Circuit determined that the sixty-day time limit on payment set forth in the 993 Regulation is valid because it is harmonious with the origin and purpose of the DISC legislation without, however, subjecting the regulation to the level of scrutiny dictated as appropriate by this Court and engaged in by the Claims Court in the case below. The Federal Circuit was influenced by its understanding that both the Second and Eleventh Circuits had upheld the sixty-day payment provisions of the 993 Regulation. *See CWT Farms, Inc. v. Commissioner*, 755 F.2d 790 (11th Cir. 1985), *aff'g* 79 T.C. 1054 (1982); *LeCroy Research Systems Corp. v. Commissioner*, 751 F.2d 123 (2d Cir. 1984), *rev'g on other grounds*, 47 T.C.M. (CCH) 1345 (1984). With the exception of the Claims Court in the case below, each court that has ad-

dressed the validity issue has been satisfied with the Government's justification for promulgation of the challenged regulation: that the regulation is necessary to prevent potential circumvention of the producer's loan limitations of Code Section 993(d). The producer's loan limitations set forth detailed requirements for qualifying a loan made by a DISC to a supplier as a qualified export asset under Code Section 993(b). These limitations were designed to ensure that a producer would not divert the tax-deferred dollars of the DISC into non-export activities. The sixty-day payment requirement of the 993 Regulation has been accepted by all courts except the Claims Court as a "reasonable requirement . . . imposed as a condition of permitting DISCs to include commissions due from related producers in their qualified export assets as accounts receivable." *Thomas International Limited v. United States*, 773 F.2d 300, 304-05 (Fed. Cir. 1985).

The Claims Court, on the other hand, recognized that the 993 Regulation is invalid because, in drawing a distinction between commissions receivable from a DISC's related supplier and accounts receivable from unrelated persons, the Commissioner added a condition or exception to the statutory language. *Thomas International*, 6 Cl. Ct. 414, 419-20. Furthermore, the Claims Court rejected the Tax Court's conclusion in *CWT Farms, Inc. v. Commissioner*, 79 T.C. 1054 (1982), *aff'd*, 755 F.2d 790 (11th Cir. 1985), *petition for cert. filed* June 14, 1985, that Code Section 993(b)(3) is ambiguous, and found that in light of the entire statute any alleged ambiguity was "more apparent than real." *Thomas International*, 6 Cl. Ct. at 419. The Claims Court held that the statute is not ambiguous because Code Section 993(f), which defines "gross receipts" in the case of a commission DISC, and Code Section 994(b), which authorizes regulations for pricing rules "in the case of commissions," show that

Congress intended that commission DISCs be treated on equal footing with DISCs that buy goods from related suppliers for resale to third parties. If a commission DISC, which would not ordinarily have substantial tangible assets, were required by the statute to exclude its commissions receivable from qualified export assets while including them in its total assets, it could never meet the qualified export assets test of Code Section 992(a)(1)(B) and could never qualify as a DISC. Therefore, as the Claims Court recognized, the term "accounts receivable" as used in Code Section 993(b)(3), "must necessarily be understood to include sales in which the DISC is assigned by the producer the role of commission agent rather than reseller." *Id.*

The Claims Court therefore held that the sixty-day payment requirement of the 993 Regulation is not sustainable as an interpretation of any statutory language, and further characterized the 993 Regulation as "an effort to close a loophole by adding a requirement to the statute which Congress failed to adopt." *Thomas International*, 6 Cl. Ct. at 420. The Claims Court also recognized that the 993 Regulation added an arbitrary requirement that created a conclusive presumption against the taxpayer regardless of any bona fide reasons that might exist for failure to pay commissions within sixty days. *Id.*

The Federal Circuit, while recognizing that the 993 Regulation was interpretive and therefore subject to less deference than a legislative regulation, found that the words "accounts receivable" in the statute did not unambiguously include commissions receivable and that the Commissioner, therefore, "had leeway to define and apply the statutory term so as properly and effectively to implement the congressional plan and purpose in the DISC provisions." *Thomas International*, 773 F.2d at 304. The Federal Circuit also noted that the Tax Court, the Second Circuit and the Eleventh Circuit have upheld

the 993 Regulation and aligned itself with these courts on the validity issue. The Second Circuit, however, did not address the validity of the 993 Regulation, but did uphold the validity of Treas. Reg. § 1.994-1(e), a regulation which addresses payment of commissions but does not govern qualification of such commissions as qualified export assets. *LeCroy*, 751 F.2d at 125-26. The Eleventh Circuit did address the validity of the 993 Regulation but did not analyze the 993 Regulation using the criteria established by this Court. The failure of the Eleventh Circuit properly to analyze the regulation is currently the subject of a petition for certiorari filed with this Court on June 14, 1985. In addition, there remains the possibility of a conflict among the circuit courts of appeal on the issue of the validity of the 993 Regulation because the Seventh Circuit has under consideration the *Gehl* case. *Gehl Co. v. Commissioner*, 49 T.C.M. (CCH) 372 (1984), *appeal docketed*, No. 85-1326 (7th Cir. Feb. 26, 1985).

II. The Issues Whether Commissions Receivable Constitute Accounts Receivable Under Code Section 993(b)(3) And Whether Substantial Compliance With The 993 Regulation Is Sufficient Present Important Questions Of Federal Law Not Previously Decided By The Court.

Many taxpayers across the country have run afoul of the Treasury's unreasonable interpretation of Code Section 993(b)(3). These taxpayers have uniformly expressed their dismay that provisions originally enacted to promote exports and thereby lessen the balance of payments deficit have operated, through Treasury interpretation, to punish taxpayers operating in strict conformity with the applicable Code sections.

An appreciation of the significance of the federal law questions presented necessitates a brief review of the history of the DISC legislation. The DISC provisions were enacted as part of the Revenue Act of 1971, Pub.

L. No. 92-178, 85 Stat. 497 (1971). A DISC is merely a device that was designed to encourage exports of domestic products. The DISC provisions of the Code were passed as a means of placing domestic corporations engaged in export activities on a par with corporations using foreign subsidiaries. S. Rep. No. 437, 92d Cong., 1st Sess., *reprinted in* 1971 U.S. Code & Ad. News 1918; 1972-1 C.B. 559, 609. Prior to enactment of these provisions, domestic corporations were taxed currently on their foreign earnings regardless of whether those earnings were kept abroad or brought back into the United States. S. Rep. No. 92-437, 92d Cong., 1st Sess., *reprinted in* 1971 U.S. Code & Ad. News at 1996; 1972-1 C.B. at 609. Corporations using foreign subsidiaries, however, were generally only taxed on their foreign earnings when they were repatriated. S. Rep. No. 437, 92d Cong., 1st Sess., *reprinted in* 1971 U.S. Code & Ad. News at 1996; 1972-1 C.B. at 609.

Congress sought to increase the export of domestic products and thereby (1) improve the balance of payments that had been deteriorating during the 1960's and early 1970's and (2) reduce the unemployment rate which had increased significantly during this same period. S. Rep. No. 437, 92d Cong., 1st Sess., *reprinted in* 1971 U.S. Code & Ad. News at 1923; 1972-1 C.B. at 562. The method employed to accomplish those goals was a tax incentive for exporters in the form of a deferral of federal income taxes on export income earned by a DISC until the DISC distributed its earnings.

The DISC provisions introduced several new concepts into the area of foreign taxation. The DISC itself is not subject to tax. Rather, its shareholders are taxed directly on a specified percentage of the DISC's current taxable income as if a dividend distribution of that amount had been made at the end of the taxable year. The remainder of the DISC's income remains untaxed until it is distributed to its shareholders, the shareholder-

ers dispose of their DISC stock, or the DISC loses its special status. The DISC benefits were intended by Congress "to encourage reinvestment of the exempt earnings in export activities." *LeCroy*, 751 F.2d at 124.

In addition to the substantial tax savings enjoyed by a DISC, several rules of taxation are waived. Contrary to the treatment afforded other entities under the tax law, a DISC may be merely a "shell" corporation whose sole function is its use as an accounting device for measuring the amount of export earnings subject to tax deferral. Provided it meets certain intercompany pricing rules, the DISC can enter into agreements with related parties without worrying about the "arm's-length transaction" requirements that other entities must use in dealing with related parties. *See* Code Section 994.

Congress expected that the exporting activity would take place not at the DISC level, but at the producer level. The statutory scheme therefore provides mechanisms for returning cash of a DISC to a producer for use in furthering the producer's export activities. Consistent with Congress' objective of promoting exports, a producer's deferral of tax on export profits through use of a DISC was not predicated upon leaving profits in the DISC. Instead, the list of qualified export assets in Code Section 993(b) was designed to facilitate the return of a DISC's income to its supplier for use in the supplier's export efforts. *See Caterpillar Tractor Co. v. United States*, 589 F.2d 1040 (Ct. Cl. 1978).

Code Section 993(b)(3) states that a DISC's accounts receivable and evidences of indebtedness are qualified export assets if they arise from qualified export receipts generated by any of the export-related transactions described in Code Section 993(a)(1)(A), (B), (C), (D), (G) or (H). The statute focuses on the type of transaction giving rise to the receivable (whether it arose from export activity) and not on the type of re-

ceivable (whether it is owed by a related party) generated by the export activity. The 993 Regulation departs radically from the statute's approach by providing that "accounts receivable and evidences of indebtedness" representing commissions are trade receivables, and thus qualified export assets, but then requiring that their status as qualifying assets be forfeited if they are owed a DISC by its related supplier and are not paid within sixty days of the close of the DISC's taxable year. The Code neither mentions the term "trade receivables," nor requires that accounts receivable and evidences of indebtedness of a DISC be paid within a certain time in order to remain qualified export assets. Indeed, Code Section 992(a)(1)(B) requires that the qualified export asset test be applied at the close of the DISC's taxable year, and not at some time thereafter. Both exceptions to the general rule requiring that the qualified export asset test be satisfied at the close of the taxable year allow more permissive time limitations. *See* Code Section 992(c)(1)(B) and Treas. Reg. § 1.993-2(j).

To superimpose upon the liberal statutory scheme a rigid sixty-day payment requirement that operates to the detriment of taxpayers such as Petitioner who have adhered to the letter of the statute is patently unreasonable. The vice of the challenged regulation lies in its sweeping application to situations other than the one it was designed to prevent: circumvention of the producer's loan limitations. Petitioner has established and the Government has acknowledged that the evils the regulation was intended to prevent did not exist in this case.

A second important question, considering both the legislative history and the text of the statute, is whether substantial compliance with the 993 Regulation is sufficient. Courts below have uniformly held that the regulation is substantive and therefore strict compliance therewith is mandatory.

Petitioner submits that, because the essence of the DISC statutes is to promote exports, the requirement of the 993 Regulation that payment of a DISC's commissions receivable from a related supplier be received within sixty days of the close of the DISC's taxable year is procedural and directory. The 993 Regulation does not rise above its purely procedural function of ensuring timely payment of commissions owed a related party except insofar as it operates to prevent circumvention of the producer's loan limitations of Code Section 993 (d). Where those limitations have not been violated, as in the Petitioner's case, the 993 Regulation cannot be other than procedural. Substantial compliance with a procedural regulation is sufficient if such compliance does not operate to the prejudice of the Commissioner. *American Air Filter Co. v. Commissioner*, 81 T.C. 709 (1983); *Tipps v. Commissioner*, 74 T.C. 458 (1980).

The Federal Circuit, following the Tax Court opinion on the issue, ruled that substantial compliance with the 993 Regulation is not sufficient because the regulation is a substantive rule. *Thomas International*, 773 F.2d at 305. *See Gehl*, 49 T.C.M. (CCH) 372, 375-76 (1984); *Fritzsche, Dodge & Olcott, Inc. v. Commissioner*, 45 T.C.M. (CCH) 607, 609-10 (1983). This ruling ignored Petitioner's arguments that the 993 Regulation can only serve a procedural function when set in the context of a situation in which there exists no possibility for violation of the producer's loan limitations. The ruling also failed to probe the evidence presented by Petitioner of its methods of substantial compliance with the 993 Regulation. TIL had demonstrated that it met the sixty-day payment requirement either by (i) receiving a check representing the commission owed it within a reasonable time after the close of each taxable year, (ii) the automatic transfer of Thomas' export accounts receivable to TIL in order to offset TIL's commissions receivable or (iii) the making of an accounting entry offsetting TIL's obligation to purchase Thomas' export accounts

receivable. Treas. Reg. § 1.994-1(e)(3)(ii) sanctions any of these methods of payment.

CONCLUSION

The Federal Circuit's failure to analyze the validity of the 993 Regulation in light of the criteria enunciated by this Court, particularly when confronted with facts such as those involved in this case, justifies a grant of review to reinforce this Court's standards for analysis of the Treasury's interpretive authority under Code Section 7805.

The Federal Circuit's decision also raises two important questions of law not previously addressed by this Court: whether commissions receivable constitute accounts receivable under Code Section 993(b)(3) and whether substantial compliance with an interpretive regulation is sufficient.

Petitioner therefore respectfully requests that this Court grant its petition for a writ of certiorari.

Respectfully submitted,

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APPENDIX

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

Appeal No. 85-870

THOMAS INTERNATIONAL LIMITED,
Appellee,

v.

THE UNITED STATES,
Appellant.

DECIDED: September 18, 1985

Before FRIEDMAN, *Circuit Judge,* SKELTON, *Senior Circuit Judge,* and BISELL, *Circuit Judge.*

FRIEDMAN, *Circuit Judge.*

This is an appeal by the United States from a judgment of the United States Claims Court granting summary judgment to the appellee taxpayer in its tax refund suit. The court held invalid, as unauthorized by the governing statute, a Treasury Regulation pursuant to which the Commissioner of Internal Revenue had denied the appellee the special tax treatment available to a domestic international sales corporation (DISC) that meets specified statutory criteria. We uphold the regulation, reverse the judgment of the Claims Court, and remand the case with instructions to grant the government's motion for summary judgment and to dismiss the suit.

I

A. The DISC provisions of the Internal Revenue Code of 1954, 26 U.S.C. §§ 991-995 (1976) were added to the Code in 1971. Revenue Act of 1971, Pub. L. No. 92-178, Title V, 85 Stat. 535. Their purpose was to provide tax incentives for United States firms to increase their exports and to remove the previous tax disadvantage of firms engaged in export activities through domestic corporations instead of through foreign subsidiaries. *See* H.R. Rep. No. 533, 92d Cong., 1st Sess. 58, *reprinted in* 1971 U.S. Code Cong. & Ad. News 1825, 1872; S. Rep. No. 437, 92d Cong., 1st Sess., *reprinted in* 1971 U.S. Code Cong. & Ad. News 1918. The basic scheme allows a domestic production company to establish a DISC to handle its export sales and leases. The DISC may be no more than a shell corporation, which performs no functions other than to receive commissions on foreign sales made by its parent.

The DISC is not subject to federal income tax on its "earnings." Instead, part of the DISC's earnings are taxed to its shareholder(s) as constructive dividends and the remainder is taxed only when actually distributed. The exempted earnings must be reinvested in export activities. *See generally* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.14 (4th ed. 1979).

To insure that these tax-deferred profits actually are used for export activities and are not diverted to either production for the domestic market or for manufacturing overseas, Congress provided strict requirements for qualification as a DISC. A corporation that elects DISC treatment must satisfy the income and assets tests set forth in section 992(a)(1).

At least 95 percent of a DISC's gross receipts must consist of "qualified export receipts," which section 993(a)(1) defines as receipts derived from the sale or lease

of export property for use outside the United States and from related services. Similarly, at least 95 percent of a DISC's assets must consist of "qualified export assets" which section 993(b) defines as including "accounts receivable and evidences of indebtedness which arise by reason of [specified] transactions of such corporations" that relate to export activities and generate qualified export receipts. The failure to meet either the income or the assets test results in the corporation's loss of DISC status and the recapture of the previously deferred income. § 995(b)(2).

A key element of the DISC scheme is the "producer's loan" provisions of section 993(d). By means of such loans a DISC may make its tax-deferred earnings available to the parent corporation for reinvestment in export activity without jeopardizing its DISC status, since producer's loans qualify as export assets. Section 993(d) provides detailed and complex requirements for producer's loans to insure that the DISC's tax-deferred earnings are used only in the parent corporation's export activities. *See CWT Farms, Inc. v. Comm'r*, 755 F.2d 790 (11th Cir. 1985).

The implementing Treasury Regulations provide that the commissions a DISC receives from a related supplier may be treated as qualified export assets, but only if paid within 60 days of the close of the DISC's taxable year. Section 1.993-2(d)(2) provides in pertinent part:

> If a DISC acts as commisison agent for a principal in a transaction . . . which results in qualified export receipts for the DISC, and if an account receivable or evidence of indebtedness held by the DISC and representing the commission payable to the DISC as a result of the transaction arises . . . , such account receivable or evidence of indebtedness shall be treated as a . . . [qualified export asset]. If, however, the principal is a related supplier (as defined

> in § 1.994-1(a)(3)) with respect to the DISC, such account receivable or evidence of indebtedness will not be treated as a . . . [qualified export asset] unless it is payable and paid in a time and manner which satisfy the requirements of § 1.994-1(e)(3) . . . .

Section 1.994-1(e)(3) in turn provides:

> The amount of . . . a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related supplier . . . must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.

The validity of this 60-day payment requirement in the Regulations is the issue in this case.

B. The relevant facts of this case, set forth in greater detail in the Claims Court's opinion, 61 Cl. Ct. 414 (1984), are not in dispute. The appellee Thomas International Limited (Thomas), a wholly owned subsidiary of Thomas Built Buses, Inc. (Thomas Buses), was organized as a commission DISC. Thomas accrued commissions on all of Thomas Buses' export sales. For the taxable years ending March 31, 1977 and 1978, Thomas' respective commissions were $708,231 and $329,057, which it entered as accounts receivable on its books. Thomas Buses did not issue checks to Thomas for the commissions until December 15, 1977 and June 1, 1978, respectively. This was 8½ months after the close of Thomas' 1977 taxable year and 62 days after the close of its 1978 taxable year. Since Thomas claimed qualification as a DISC, it paid no taxes for either year.

The Internal Revenue Service assessed deficiencies on Thomas. It ruled that Thomas did not qualify as a DISC for those taxable years because Thomas had not met the qualified export assets test of section 992(a)(1)(B). The Service concluded the the accrued commissions were not qualified export assets because they were not paid

to Thomas within 60 days after the close of each taxable year, as Treasury Regulation § 1.993-2(d)(2) required.

Thomas paid the deficiency, and when its refund claim was disallowed, filed the present suit in the Claims Court. On cross-motions for summary judgment the Claims Court granted Thomas' and denied the government's motion. The court held that the 60-day payment requirement for commissions receivable in regulation 1.993-2 (d)(2) was unauthorized by, and in fact contrary to, the DISC statute. Since the United States conceded it had no other defense on the merits, the court concluded that Thomas was entitled to judgment as a matter of law.

The Court ruled that in light of the entire DISC statute, the term "accounts receivable . . . which arise by reason of [export] transactions of such corporation" unambiguously includes commissions receivable. It reasoned that Congress intended to allow a DISC to operate as a commission agent as well as a reseller of goods and that most commission DISC's could not meet the 95 percent export assets test if its commissions receivable were excluded. The court stated that "even if there were an ambiguity with respect to whether or not the accounts receivable which arise by sales in which the DISC is merely the agent, it has been resolved by provisions of Treasury Regulation § 1.993-2(d)(2) other than the 60-day payment requirement." 6 Cl. Ct. at 419. The court concluded that the 60-day payment rule could not "be deemed to be merely an interpretation of any statutory phrase but is an additional requirement superimposed thereon for another purpose." *Id.*

The court then held that the regulation was not sustainable as a reasonable means of preventing the circumvention of the "producer's loan" provisions. It stated that the Treasury may not add requirements which Con-

gress failed to adopt "to close a loophole" unless Congress delegated specific legislative or rule-making authority to the Treasury. The court found that the 60-day payment requirement

> attempts to resolve a question of substance versus form by making conclusive against the taxpayer what would otherwise be only a single factor in that factual inquiry. It denies the taxpayer the opportunity to prove that the funds which could have been used to pay the commisisons were in fact used by the related supplier as export assets for purposes consistent with those permissible for producer's loans. And it also makes irrelevant any proof that the failure of the agent to receive payment of the commissions within the 60 days may have been for bona fide reasons, such as hardship, inadvertence, failure of the customer to make prompt payment, uncertainty as to amount or difficulty in computation, rather than as a device to circumvent the producer's loan restrictions."

Id. at 420.

II

The regulations for section 993 were promulgated pursuant to the Treasury's general authority under section 7805(a) to "prescribe all needful rules and regulations for the enforcement of this title." *See* 37 Fed. Reg. 20853 (1972). They are thus entitled to less deference than regulations issued pursuant to specific legislative authority. *See Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981). Nevertheless, our role in reviewing the regulations is limited. We "must defer to Treasury Regulations that 'implement the Congressional mandate in some reasonable manner.'" *Commissioner v. Portland Cement Co.*, 450 U.S. 156, 169 (1981), *quoting United States v. Correll*, 389 U.S. 299, 307 (1967). "Treasury Regulations 'must be sustained unless unreasonable and

plainly inconsistent with the revenue statutes.' " *Portland Cement, supra, quoting Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). An interpretive regulation, such as is here involved, is valid if it "harmonizes with the statute's 'origin and purpose' " and language. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 26 (1982).

The Tax Court and the Second and Eleventh Circuits have upheld the 60-day payment provision of the regulation. *CWT Farms, Inc. v. Comm'r*, 755 F.2d 790 (11th Cir. 1985), *aff'g* 79 T.C. 1054 (1982); *LeCroy Research Systems Corp. v. Comm'r*, 751 F.2d 123 (2d Cir.), *rev'g on other grounds* 47 T.C.H. (CCH) 1345 (1984). Like those courts, we conclude that the provision validly implements the statutory purpose, and constitutes a permissible exercise of the Commission's broad authority to prescribe "needful rules and regulations for the enforcement of" the DISC provisions.

A. The Treasury's authority to promulgate interpretive regulations is more circumscribed when the regulation purports to clarify a statutory term that Congress has defined with considerable specificity or that is otherwise unambiguous. *United States v. Vogel Fertilizer Co.*, 455 U.S. at 24. Contrary to the view of the Claims Court, however, we cannot conclude that the statutory term "accounts receivable . . . which arise by reason of [specified] transactions of such corporation" in section 993(b) unambiguously includes commissions receivable.

The term "accounts receivable" ordinarily connotes amounts due in return for goods or services supplied. A commission paid in return for selling activities, either a fixed amount or a percentage of the sales price, normally would not be described as an account receivable. That is particularly so with respect to the commissions involved in this case, which were paid not for any services the DISC provided, but as a method Congress sanc-

tioned to enable domestic companies to shield from immediate taxation a portion of their income derived from export activities.

The specified transactions of a DISC that create qualified export assets all involve the sale or exchange of export property and other qualified export assets and services that relate to any such disposition "of such corporation." § 993(a)(1). A commission DISC such as Thomas does not engage in any sales of export property or related services but is a mere shell. The commissions due Thomas from Thomas Buses do not arise from the export transactions "of such corporation," i.e., of Thomas, since the latter itself engage in no export transactions. The present situation stands in sharp contrast to a DISC that actually made the export sales and obtained its profit either by receiving a commission or other fee on such sales, or from the difference between the cost and selling price of the goods themselves.

Although Congress intended that DISCs could also function as commission agents, it does not follow that in using the term "accounts receivable" Congress necessarily intended to include "commissions receivable."

In sum, the words "accounts receivable" do not unambiguously include commissions receivable. The Commissioner, therefore had leeway to define and apply the statutory term so as properly and effectively to implement the congressional plan and purpose in the DISC provisions.

B. We agree with the Eleventh Circuit's conclusion in *CWT Farms* that the 60-day commission payment provision in the Regulations is valid because it is "harmonious with the origin and purpose of the DISC legislation." 755 F.2d at 802.

In permitting commissions to be treated as "accounts receivable" in determining qualified export assets, the Commissioner properly recognized the danger that un-

less strictly controlled, commissions could be a means of evading the strict requirements and limitations Congress placed upon producer loans. These restrictions were designed to insure that a producer would not divert the tax-immunized DISC funds into non-export activities. *CWT Farms*, 655 F.2d at 796. Unless promptly paid, commissions due a DISC from its parent in effect create an open line of credit, upon which the parent can draw at will for whatever purposes it wishes.

Congress, however, provided a mechanism whereby a DISC's tax-deferred earnings could be reinvested only in export activities. This objective was accomplished in part through the producer's loan provisions of section 993(d).

In general, the cumulative amount a DISC may lend to a producer may not exceed the amount of (a) the latter's export related assets and (b) the accumulated DISC income. § 993(d)(1)(A) & (d)(2). These restrictions on the amount of loans, as well as the other statutory requirements, could be easily circumvented if there were no time limit on the payment of commissions owed by a related supplier. The requirement that a related producer pay commissions to a DISC within 60 days of the end of the DISC's taxable year supports, protects, and prevents evasions of the producer's loan provisions.

Unlike the Claims Court, we do not view the 60-day payment regulation as an improper attempt by the Commissioner to create an additional requirement that Congress did not impose. To the contrary, we think the regulation constituted a reasonable requirement the Commissioner validly imposed as a condition of permitting DISCs to include commissions due from related producers in their qualified export assets as accounts receivable. As the Eleventh Circuit described the provision in *CWT Farms*, it does "no more than set a due date for the payment of commissions receivable." 755 F.2d at 802.

Thomas does not contend that the 60-day time limit is arbitrary because it does not give the related producer sufficient time within which to calculate and pay the commissions due to the DISC. Indeed, Thomas could not properly make that argument, since the regulations require that only a reasonable estimate of the actual commissions due need be paid within 60 days, and state that a 50 percent payment shall be deemed a reasonable estimate of such commissions. § 1.994-1(e)(3)(iv).

In invalidating the regulation, the Claims Court stated that the DISC should be allowed to prove that the funds which would have been used to pay the commissions were in fact used by the related supplier for purposes consistent with the producer's loan provisions. The court further criticized the 60-day payment rule on the ground that there may have been "bona fide reasons" for a related producer's failure to make timely payment, which the rule precluded the DISC from establishing.

The 60-day payment requirement is a prophylactic measure. For such a measure to be effective, some time limit upon payments of commissions to DISCs is necessary—as the Claims Court itself recognized. The "particular facts and circumstances" standard that the Claims Court apparently deemed appropriate for dealing with the problem would be impossible to administer, would substitute doubt and uncertainty for the definiteness the regulation provides, and would seriously weaken the effectiveness of the regulation in guarding against evasion of the purchaser's loan requirements. Since we hold the regulation to be valid, it is immaterial that the particular situation in which it is applied may not involve the evils the regulation was intended to prevent. *Cf. North American Co. v. Securities and Exchange Commission*, 327 U.S. 686, 710-11 (1946).

III

Thomas attempts to uphold the judgment of the Claims Court on the alternative ground that even if the regu-

lation is valid, Thomas has substantially complied with it. Thomas argues that the regulation is procedural and not substantive, that the commissions were timely paid through certain accounting entries made by itself and Thomas Buses, and that Thomas Buses had sufficient export accounts receivable to allow reinvestment of Thomas' accumulated DISC income that reflected the commissions.

We reject this argument. The regulation is not merely procedural but is a substantive rule that determines whether commissions receivable constitute qualified export assets. *See Gehl Co. v. Comm'r*, 49 T.C.M. (CCH) 372, 375-76 (1984); *Fritzsche, Dodge & Olcott, Inc. v. Comm'r*, 45 T.C.M. (CCH) 607, 609-10 (1983). Substantive regulatory requirements must be complied with fully. *Fritzsche, Dodge & Olcott* at 609; *Tipps v. Comm'r*, 74 T.C. 458 (1980).

The requirement in the regulation is unequivocal: for commissions receivable to constitute qualified export assets, they must be paid within 60 days after the end of the DISC's taxable year. Assuming *arguendo* that substantial rather than literal compliance satisfies this requirement, the fact that (a) Thomas and Thomas Buses might have made payment through offsetting accounting entries, as the regulation permitted, § 1.994-1 (e)(3)(ii), but which they did not do within the 60-day period, or (b) that the failure to make timely payment may not have resulted in evasion of the producer's loan standards, does not establish substantial compliance with the regulation.

CONCLUSION

The judgment of the United States Claims Court is reversed and the case is remanded with instructions to grant the United States' motion for summary judgment and dismiss the suit.

REVERSED and REMANDED

IN THE UNITED STATES CLAIMS COURT

No. 449-81T

THOMAS INTERNATIONAL LIMITED,
Plaintiff

v.

THE UNITED STATES,
Defendant

(Filed October 24, 1985)

ORDER

Pursuant to the mandate of the United States Court of Appeals for the Federal Circuit issued October 17, 1985, defendant's motion for summary judgment is allowed. The judgment entered October 12, 1984, is vacated, and the clerk is directed to enter judgment dismissing plaintiff's complaint.

/s/ Philip R. Miller
PHILIP R. MILLER
Judge

STATUTES AND REGULATIONS

I.R.C. § 992(a):

(a) Definition of "DISC" and "Former DISC".—

(1) DISC.—For purposes of this title, the term "DISC" means, with respect to any taxable year, a corporation which is incorporated under the laws of any State and satisfies the following conditions for the taxable year:

(A) 95 percent or more of the gross receipts (as defined in section 993(f) of such corporation consist of qualified export receipts (as defined in section 993(a)),

(B) the adjusted basis of the qualified export assets (as defined in section 993(b) of the corporation at the close of the taxable year equals or exceeds 95 percent of the sum of the adjusted basis of all assets of the corporation at the close of the taxable year,

(C) such corporation does not have more than one class of stock and the par or stated value of its outstanding stock is at least $2,500 on each day of the taxable year,

(D) the corporation has made an election pursuant to subsection (b) to be treated as a DISC and such election is in effect for the taxable year, and

(E) such corporation is not a member of any controlled group of which FSC is a member.

(2) Status as DISC after having filed a return as a DISC.—The Secretary shall prescribe regulations setting forth the conditions under and the

extent to which a corporation which has filed a return as a DISC for a taxable year shall be treated as a DISC for such taxable year for all purposes of this title, notwithstanding the fact that the corporation has failed to satisfy the conditions of paragraph (1).

(3) "Former DISC".—For purposes of this title, the term "former DISC" means, with respect to any taxable year, a corporation which is not a DISC for such year but was a DISC in a preceeding taxable year and at the beginning of the taxable year has undistributed previously taxed income or accumulated DISC income.

I.R.C. § 993(a):

(a) Qualified Export Receipts.—

(1) General rule.—For purposes of this part, except as provided by regulations under paragraph (2), the qualified export receipts of a corporation are—

(A) gross receipts from the sale, exchange, or other disposition of export property,

(B) gross receipts from the lease or rental of export property, which is used by the lessee of such property outside the United States,

(C) gross receipts for services which are related and subsidiary to any qualified sale, exchange, lease, rental, or other disposition of export property by such corporation,

(D) gross receipts from the sale, exchange, or other disposition of qualified export assets (other than export property),

(E) dividends (or amounts includible in gross income under section 951) with respect to stock of a related foreign export corporation (as defined in subsection (e)),

(F) interest on any obligation which is a qualified export asset,

(G) gross receipts for engineering or architectural services for construction projects located (or proposed for location) outside the United States, and

(H) gross receipts for the performance of managerial services in furtherance of the production of other qualified export receipts of a DISC.

(2) Excluded receipts.—The Secretary may under regulations designate receipts from the sale, exchange, lease, rental, or other disposition of export property, and from services, as not being receipts described in paragraph (1) if he determines that such sale, exchange, lease, rental, or other disposition, or furnishing of services—

(A) is for ultimate use in the United States;

(B) is accomplished by a subsidy granted by the United States or any instrumentality thereof;

(C) is for use by the United States or any instrumentality thereof where the use of such export property or services is required by law or regulation.

For purposes of this part, the term "qualified export receipts" does not include receipts from a corporation which is a DISC for its taxable year in which the receipts arise and which a member of a

controlled group (as defined in paragraph (3)) which includes the recipient corporation.

(3) Definition of controlled group.—For purposes of this part, the term "controlled group" has the meaning assigned to the term "controlled group of corporations" by section 1563(a), except that the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears therein, and section 1563 (b) shall not apply.

I.R.C. § 993(b):

(b) Qualified Export Assets.—For purposes of this part, the qualified export assets of a corporation are—

(1) export property (as defined in subsection (c));

(2) assets used primarily in connection with the sale; lease, rental, storage, handling, transportation, packaging, assembly, or servicing of export property, or the performance of engineering or architectural services described in subparagraph (G) of subsection (a)(1) or managerial services in furtherance of the production of qualified export receipts described in subparagraphs (A) (B), (C), and (G) of subsection (a)(1);

(3) accounts receivable and evidences of indebtedness which arise by reason of transactions of such corporation or of another corporation which is a DISC and which is a member of a controlled group which includes such corporation described in subparagraphs (A, (B), (C), (D), (G), or (H), of subsection (a)(1);

(4) money, bank deposits, and other similar temporary investments, which are reasonably neces-

sary to meet the working capital requirements of such corporation;

(5) obligations arising in connection with a producer's loan (as defined in subsection (d));

(6) stock or securities of a related foreign export corporation (as defined in subsection (e));

(7) obligations issued, guaranteed, or insured, in whole or in part, by the Export-Import Bank of the United States or the Foreign Credit Insurance Association in those cases where such obligations are acquired from such Bank or Association or from the seller or purchaser of the goods or services with respect to which such obligations arose;

(8) obligations issued by a domestic corporation organized solely for the purpose of financing sales of export property pursuant to an agreement with the Export-Import Bank of the United States under which such corporation makes export loans guaranteed by such bank; and

(9) amounts (other than reasonable working capital) on deposit in the United States that are utilized during the period provided for in, and otherwise in accordance with, regulations prescribed by the Secretary to acquire other qualified export assets.

I.R.C. § 993(d):

(d) Producer's Loans.—

(1) In general.—An obligation, subject to the rules provided in paragraphs (2) and (3), shall be treated as arising out of a producer's loan if—

(A) the loan, when added to the unpaid balance of all other producer's loans made by

the DISC, does not exceed the accumulated DISC income at the beginning of the month in which the loan is made;

(B) the obligation is evidenced by a note (or other evidence of indebtedness) with a stated maturity date not more than 5 years from the date of the loan;

(C) the loan is made to a person engaged in the United States in the manufacturing, production, growing, or extraction of export property determined without regard to subparagraph (C) or (D) of subsection (c)(2), (referred to hereinafter as the "borrower"); and

(D) at the time of such loan it is designated as a producer's loan.

(2) Limitation.—An obligation shall be treated as arising out of a producer's loan only to the extent that such loan, when added to the unpaid balance of all other producer's loans to the borrower outsanding at the time such loan is made, does not exceed an amount determined by multiplying the sum of—

(A) the amount of the borrower's adjusted basis determined at the beginning of the borrower's taxable year in which the loan is made, in plant, machinery, and equipment, and supporting production facilities in the United States;

(B) the amount of the borrower's property held primarily for sale, lease, or rental, to customers in the ordinary course of trade or business, at the beginning of such taxable year; and

(C) the aggregate amount of the borrower's research and experimental expenditures (within the meaning of section 174) in the United States during all preceding taxable years beginning after December 31, 1971.

by the percentage which the borrower's receipts, during the 3 taxable years immediately preceding the taxable year (but not including any taxable year commencing prior to 1972) in which the loan is made, from the sale, lease, or rental outside the United States of property which would be export property (determined without regard to subparagraph (C) or (D) of subsection (c)(2)) if held by a DISC is of the gross receipts during such 3 taxable years from the sale, lease, or rental of property held by such borrower primarily for sale, lease, or rental to customers in the ordinary course of the trade or business of such borrower.

(3) Increased investment requirements.—An obligation shall be treated as arising out of a producer's loan in a taxable year only to the extent that such loan, when added to the unpaid balance of all other producer's loans to the borrower made during such taxable year, does not exceed an amount equal to—

(A) the amount by which the sum of the adjusted basis of assets described in paragraph (2)(A) and (B) on the last day of the taxable year in which the loan is made exceeds the sum of the adjusted basis of such assets on the first day of such taxable year; plus

(B) the aggregate amount of the borrower's research and experimental expenditures (within the meaning of section 174) in

the United States during such taxable year.

(4) Special limitation in the case of domestic film maker.—

(A) In general.—In the case of a borrower who is a domestic film maker and who incurs an obligation to a DISC for the making of a film, and such DISC is engaged in the trade or business of selling, leasing, or renting films which are export property, the limitation described in paragraph (2) may be determined (to the extent provided under regulations prescribed by the Secretary) on the basis of—

(i) the sum of the amounts described in subparagraphs (A), (B), and (C) thereof plus reasonable estimates of all such amounts to be incurred at any time by the borrower with respect to films which are commenced within the taxable year in which the loan is made, and

(ii) the percentage which, based on the experience of producers of similar films, the annual receipts of such producers from the sale, lease, or rental of such films outside the United States is of the annual gross receipts of such producers from the sale, lease, or rental of such films.

(B) Domestic film maker.—For purposes of this paragraph, a borrower is a domestic film maker with respect to a film if—

(i) such borrower is a United States person within the meaning of section 7701 (a)(30), except that with respect to a

partnership, all of the partners must be United States persons, and with respect to a corporation, all of its officers and at least a majority of its directors must be United States persons;

(ii) such borrower is engaged in the trade or business of making the film with respect to which the loan is made;

(iii) the studio, if any, used or to be used for the taking of photographs and the recording of sound incorporated into such film is located in the United States;

(iv) the aggregate playing time of portions of such film photographed outside the United States does not or will not exceed 20 percent of the playing time of such film; and

(v) not less than 80 percent of the total amount paid or to be paid for services performed in the making of such film is paid or to be paid to persons who are United States persons at the time such services are performed or consist of amounts which are fully taxable by the United States.

(C) Special rules for application of subparagraph (B)(v).—For purposes of clause (v) of subparagraph (B)—

(i) there shall not be taken into account any amount which is contingent upon receipts or profits of the film and which is fully taxable by the United States (within the meaning of clause (ii)); and

(ii) any amount paid or to be paid to a United States person, to a non-resident alien individual, or to a corporation which furnishes the services of an officer or employee to the borrower with respect to the making of a film, shall be treated as fully taxable by the United States only if the total amount received by such person, individual, officer, or employee for services performed in the making of such film is fully included in gross income for purposes of this chapter.

I.R.C. § 993(f):

(f) Gross Receipts.—For purposes of this part, the term "gross receipts" means the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of trade or business, and gross income from all other sources. In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of this part as gross receipts shall be the gross receipts on the sale, lease, or rental of the property on which such commissions arose.

I.R.C. § 994:

SEC. 994. INTER-COMPANY PRICING RULES.

(a) In General.—In the case of a sale of export property to a DISC by a person described in section 482, the taxable income of such DISC and such person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

(1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts.

(2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

(b) Rules for Commissions, Rentals, and Marginal Costing.—The Secretary shall prescribe regulations setting forth—

(1) rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and

(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a DISC is seeking to establish or maintain a market for export property.

(c) Export Promotion Expenses.—For purposes of this section, the term "export promotion expenses" means those expenses incurred to advance the distribution or sale of export property for use, consumption, or distribution outside of the United States, but does not include income taxes. Such expenses shall also include freight expenses to the extent of 50 percent of the cost of shipping export property aboard airplanes owned and operated by U.S. persons or ships

documented under the laws of the United States in those cases where law or regulations do not require that such property be shipped aboard such airplanes or ships.

I.R.C. § 995(a):

(a) General Rule.—A shareholder of a DISC or former DISC shall be subject to taxation on the earnings and profits of a DISC as provided in this chapter, but subject to the modifications of this subpart.

I.R.C. § 995(b)(1):

(b) Deemed Distributions.—

(1) Distributions in qualified years.—A shareholder of a DISC shall be treated as having received a distribution taxable as a dividend with respect to his stock in an amount which is equal to his pro rata share of the sum (or, if smaller, the earnings and profits for the taxable year) of—

(A) the gross interest derived during the taxable year from producer's loans,

(B) the gain recognized by the DISC during the taxable year on the sale or exchange of property, other than property which in the hands of the DISC is a qualified export asset, previously transferred to it in a transaction in which gain was not recognized in whole or in part, but only to the extent that the transferor's gain on the previous transfer was not recognized.

(C) the gain (other than the gain described in subparagraph (B) recognized by the DISC during the taxable year on the sale or exchange of property (other than property which in the hands of the DISC is stock in trade or other

property described in section 1221(1)) previously transferred to it in a transaction in which gain was not recognized in whole or in part, but only to the extent that the transferor's gain on the previous transfer was not recognized and would have been treated as ordinary income if the property had been sold or exchanged rather than transferred to the DISC,

(D) 50 percent of the taxable income of the DISC for the taxable year attributable to military property.

(E) the taxable income of the DISC attributable to qualified export receipts of the DISC for the taxable year which exceeds $10,000,000.

(F) the sum of—

(i) one-seventeenth of the excess of the taxable income of the DISC for the taxable year, before reduction for any distribution during the year, over the sum of the amounts deemed distributed for the taxable year under subpaargraph (A), (B), (C), (D), and (E).

(ii) an amount equal to the amount determined under clause (i) multiplied by the international boycott factor determined under section 999, and

(iii) any illegal bribe, kickback, or other payment (within the meaning of section 162 (c)) paid by or on behalf of the DISC directly or indirectly to an official, employee, or agent in fact of a government, and

(G) the amount of foreign investment attributable to producer's loans (as defined in subsection (d)) of a DISC for the taxable year.

Distributions described in this paragraph shall be deemed to be received on the last day of the taxable year of the DISC in which the income was derived. In the case of a distribution described in subparagraph (G), earnings and profits for the taxable year shall include accumulated earnings and profits.

I.R.C. § 996(a)(1):

(a) Rules for Actual Distributions and Certain Deemed Distributions.—

(1) In general.—Any actual distribution (other than a distribution described in paragraph (2) or to which section 995(c) applies) to a shareholder by a DISC (or former DISC) which is made out of earnings and profits shall be treated as made—

(A) first, out of previously taxed income, to the extent thereof,

(B) second, out of accumulated DISC income, to the extent thereof, and

(C) finally, out of other earnings and profits.

I.R.C. § 6072:

(a) General Rule.—In the case of returns under section 6012, 6013, 6017, or 6031 (relating to income tax under subtitle A), returns made on the basis of the calendar year shall be filed on or before the 15th day of April following the close of the calendar year and returns made on the basis of a fiscal year shall be filed on or before the 15th day of the fourth month following the close of the fiscal year, except as otherwise provided in the following subsections of this section.

(b) Returns of Corporations.—Returns of corporations under section 6012 made on the basis of the calendar year shall be filed on or before the 15th day of

March following the close of the calendar year, and such returns made on the basis of a fiscal year shall be filed on or before the 15th day of the third month following the close of the fiscal year. Returns required for a taxable year by section 6011(e)(2) (relating to returns of a DISC) shall be filed on or before the fifteenth day of the ninth month following the close of the taxable year.

(c) Returns by Certain Nonresident Alien Individuals and Foreign Corporations.—Returns made by nonresident alien individuals (other than those whose wages are subject to withholding under chapter 24) and foreign corporations (other than those having an office or place of business in the United States) under section 6012 on the basis of a calendar year shall be filed on or before the 15th day of June following the close of the calendar year and such returns made on the basis of a fiscal year shall be filed on or before the 15th day of the 6th month following the close of the fiscal year.

(d) Returns of Cooperative Associations.—In the case of an income tax return of—

(1) an exempt cooperative association described in section 1381(a)(1), or

(2) an organization described in section 1381(a)(2) which is under an obligation to pay patronage dividends (as defined in section 1388(a)) in an amount equal to at least 50 percent of its net earnings from business done with or for its patrons, or which paid patronage dividends in such an amount out of the net earnings from business done with or for patrons during the most recent taxable year for which it had such net earnings,

a return made on the basis of a calendar year shall be filed on or before the 15th day of September following the close of the calendar year, and a return made on the basis of a fiscal year shall be filed on or before the

15th day of the 9th month following the close of the fiscal year.

(e) Organizations Exempt From Taxation Under Section 501(a).—In the case of an income tax return of an organization from taxation under section 501(a) (other than an employees' trust described in section 401(a)), a return shall be filed on or before the 15th day of the 5th month following the close of the taxable year.

I.R.C. § 7805(a):

(a) Authorization.—Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

I.R.C. § 7805(b):

(b) Retroactivity of Regulations or Rulings.—The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

Treas. Reg. § 1.993-2(a)(3):

Reg. § 1.993-2 Definition of qualified export assets.

(a) In general. For a corporation to qualify as a DISC, at the close of its taxable year it must have qualified export assets with adjusted bases equal to at least 95 percent of the sum of the adjusted bases of all its assets. An asset which is a qualified export asset under more than one paragraph of this section shall be taken into account only once in determining the sum of

the adjusted bases of all qualified export assets. Under section 993(b), the qualified export assets held by a corporation are—

(1) Export property as defined in § 1.993-3 (see paragraph (b) of this section),

(2) Business assets described in paragraph (c) of this section.

(3) Trade receivables described in paragraph (d) of this section.

(4) Temporary investments to the extent described in paragraph (e) of this section,

(5) Producer's loans as defined in § 1.993-4 (see paragraph (f) of this section),

(6) Stock or securities (described in paragraph (g) of this section) of related foreign export corporations as defined in § 1.993-5,

(7) Export-Import Bank and other obligations described in paragraph (h) of this section,

(8) Financing obligations described in paragraph (i) of this section, and

(9) Funds awaiting investment described in paragraph (j) of this section.

Treas. Reg. § 1.993-2(d):

(d) Trade receivables—(1) In general. [Reserved]

(2) Trade receivables representing commissions. If a DISC acts as commission agent for a principal in a transaction described in § 1.993-1(b), (c), (d), (e), (h), or (i) which results in qualified export receipts for the DISC, and if an account receivable or evidence of indebtedness held by the DISC and representing the commission payable to the DISC as a result of the transaction arises (and, in the case

of an evidence of indebtedness, designated on its face as representing such commission, such account receivable or evidence of indebtedness shall be treated as a trade receivable. If, however, the principal is a related supplier (as defined in § 1.994-1(a)(3)), with respect to the DISC, such account receivable or evidence of indebtedness will not be treated as a trade receivable unless it is payable and paid in a time and manner which satisfy the requirements of § 1.994-1(e)(3) or (5) (relating to initial payment of transfer price or commission and procedure for adjustments to transfer price or commission, respectively), as the case may be. However, see subparagraph (3) of this paragraph for rules regarding certain accounts receivable representing commissions payable to a DISC by its related supplier.

(3) Indebtedness arising under § 1.994-1(e). An indebtedness arising under § 1.994-1(e)(3)(iii) (relating to initial payment of transfer price or commission) in favor of a DISC is not a qualified export asset. An indebtedness arising under § 1.994-1(e)(5)(i) (relating to procedure for adjustments to transfer price or commission) in favor of a DISC is a trade receivable if it is paid in the time and manner described in § 1.994-1(e)(5)(i) and (ii) and if it otherwise satisfies the requirements of subparagraph (2) of this paragraph. If such an indebtedness is not paid in the time and manner described in § 1.994-1(e)(5)(i) and (ii), it is not a qualified export asset.

Treas. Reg. § 1.994-1(e)(3)-(5):

(3) Initial payment of transfer price or commission. (i) The amount of a transfer price (or reasonable estimate thereof) actually charged by a related supplier to a DISC, or a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related sup-

plier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transaction occurred.

(ii) Payment must be in the form of money, property (including accounts receivable from sales by or through the DISC), a written obligation which qualifies as debt under the safe harbor rule of § 1.992-1(d)(2)(ii), or an accounting entry offsetting the account receivable against an existing debt owed by the person in whose favor the account receivable was established to the person with whom it engaged in the transaction. The form of the payment to a DISC need not be a qualified export asset under § 1.993-2. However, for the requirement that the adjusted basis of the qualified export assets of the DISC at the close of its taxable year must equal or exceed 95 percent of the sum of the adjusted bases of all assets of the DISC at the close of its taxable year, see section 992(a)(1)(B).

(iii) If the district director can demonstrate, based upon the data available as of the 60th day after the close of such taxable year, that the amount actually paid did not represent a reasonable estimate of the transfer price or commission (as the case may be) to be determined under section 994 and this section, an indebtedness will be deemed to arise, from the person required to make the payment in favor of the person to whom the payment is required to be made, in an amount equal to the difference between the amount of the transfer price or commission determined under section 994 and this section and the amount (if any) actually paid and received. Such indebtedness will be deemed to arise as of the date the transaction occurred which gave rise to the indebtedness, except that, if such transaction occurred in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the indebtedness will be deemed to arise as of the date by

which payment was required under subdivision (i) of this paragraph (e)(3). Such indebtedness owed to a DISC shall be treated as an asset but shall not be treated as a trade receivable or other qualified export asset (see § 1.993-2(d)(3)) as of the end of the taxable year of the DISC in which the indebtedness is deemed to arise.

(iv)(a) Except with respect to incomplete transactions to which paragraph (c)(5)(i)(b) of this section applies, if the amount actually paid results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction as reported in its tax return for the taxable year the transaction is completed, then the amount actually paid shall be deemed to be a reasonable estimate of such transfer price or commission.

(b) With respect to incomplete transactions to which paragraph (c)(5)(i)(b) of this section applies and which were initiated during a taxable year ending after August 15, 1975, the amount actually paid shall be deemed to be a reasonable estimate of such transfer price if any one of the following three tests is met:

(1) The amount actually paid by the DISC to the related supplier in respect of the property does not exceed the related supplier's costs of goods sold (see paragraph (c)(6)(ii) of this section) with respect to the property.

(2) If the transaction is completed by the date on which the DISC's return is required to be filed for the year in which the transaction was initiated, the amount actually paid by the DISC to the related supplier in respect of the property results in the DISC realizing at least 50 percent of the DISC's taxable income from the transaction when completed.

(3) The percentage that (i) an amount equal to (a) the amount actually paid by the DISC to the related supplier in respect of the property minus (b) the related supplier's cost of goods sold with respect to the prop-

erty, bears to (ii) the related supplier's cost of goods sold in respect of the property, is not greater than 50 percent of the percentage that (iii) the combined taxable income for completed transactions of the same group as the property during the DISC's taxable year in which the incomplete transaction was initiated, bears to (iv) the cost of goods sold of the related supplier and DISC with respect to such transactions.

(c) For purposes of this subdivision (iv), whether the transfer price or commission actually paid is deemed a reasonable estimate may be determined on the basis for grouping transactions chosen by the taxpayer under paragraph (c)(5) and (7) of this section.

(v) An indebtedness arising under subdivision (iii) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by § 1.482-2(a)(2) from the 61st day after the close of the DISC's taxable year in which the transaction occurred which gave rise to the indebtedness to the date of payment. The interest so computed shall be accrued and included in the taxable income of the person to whom the indebtedness is owed for each taxable year during which the indebtedness is unpaid.

(4) Subsequent determination of transfer price or commission. The DISC and its related supplier would ordinarily determine under section 994 and this section the transfer price payable by the DISC (or the commission payable to the DISC) for a transaction before the DISC files its return for the taxable year of the transaction. After the DISC has filed its return, a redetermination of the transfer price (or commission) may only be made if permitted by the Code and the regulations thereunder. Such a redetermination would include a redetermination by reason of an adjustment under section 482 which affects the amounts which entered into the determination of the transfer price or commission.

(5) Procedure for adjustments to transfer price or commission. (i) (a) If the transfer price (or commission) for a transaction determined under section 994 is different from the price (or commission) actually charged, the person who received too small a transfer price (or commission) or paid too large a transfer price (or commission) shall establish (or be deemed to have established), at the date of the determination or redetermination under subparagraph (4) of this paragraph of the transfer price (or commission) under section 994, an account receivable from the person with whom it engaged in the transaction equal to the difference in amount between the transfer price (or commission) so determined and the transfer price (or commission) previously paid and received. If the account receivable is paid within 90 days after the date it is established (or deemed established), then as of the end of the taxable year of the DISC in which the transaction occurred which gave rise to the indebtedness, the account receivable shall be treated as an asset and, under § 1.993-2(d) (3) as a trade receivable, and thus as a qualified export asset.

(b) If, for example, during 1972, a DISC which uses the calendar year as its taxable year sold a product which it purchased that year from its related supplier and paid a price of $10,000, which price is a reasonable estimate under subparagraph (3) (iii) of this paragraph but is later determined under section 994 to be $8,000 immediately before the DISC filed its return for 1972, the DISC must be paid $2,000 (i.e., $10,000-$8,000) by its related supplier or establish an account receivable from its related supplier of $2,000. The account receivable may be paid without tax consequences, provided that such account receivable is paid within 90 days after the date it is established (or deemed established). Such account receivable paid within such 90 days will be considered to relate to the taxable year in which the trans-

action occurred which gave rise thereto rather than the taxable year during which it is established or paid.

(ii) Payment must be in a form specified in subparagraph (3) of this paragraph.

(iii) If an account receivable of a DISC described in subdivision (i) of this paragraph (e)(5) is not paid within 90 days of the date it is established (or deemed established), then, as of the end of the taxable year of the DISC in which the transaction occurred which gives rise to the indebtedness, the account receivable shall be treated as an asset except that, if the account receivable is established (or deemed established) in a taxable year of the DISC ending on or before August 15, 1975, at the taxpayer's option, the account receivable shall be treated as an asset as of the end of such taxable year. However, under § 1.993-2(d)(3), an account receivable referred to in the preceding sentence shall not be treated as a trade receiveable or other qualified export assets.

(iv) An account receivable established in accordance with subdivision (i) of this subparagraph shall bear interest at an arm's length rate, computed in the manner provided by § 1.482-2(a)(2) from the day after the date the account receivable is deemed established to the date of payment. The interest so computed shall be accrued and included in the taxpayer's taxable income for each taxable year during which the account receivable is outstanding.

(v) The procedure for adjustments to transfer price provided by this subparagraph does not apply to incomplete transactions described in paragraph (e)(5)(i)(b) of this section. Such procedure will, however, be applied to any such transaction with respect to the taxable year in which the transaction is completed.

(6) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). (i) During 1975, a DISC which uses the calendar year as its taxable year purchased a product from its related supplier and made an initial payment of $8,500. If the $8,500 were determined to be the transfer price under section 994, the DISC's taxable income from the transaction would be $1,000. Immediately before the DISC filed its return for 1975, under section 994 it is determined that the transfer price is $8,000 and the DISC's taxable income is $1,500. Thus, the requirement of a reasonable estimate under subparagraph (3) of this paragraph was met because the amount ($8,500) actually paid resulted in the DISC realizing taxable income of $1,000 which is not less than 50 percent of the DISC's taxable income ($1,500) from the transaction as determined under section 994.

(ii) Pursuant to subparagraph (5) of this paragraph, an account receivable due the DISC for $500, i.e., $8,500-$8,000, is established on September 15, 1976, the date the DISC files its return for 1975, and is paid on December 1, 1976. The account receivable for $500 will be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto and will be a qualified export asset under § 1.993-2(d)(3) for the last day of such year.

Example (2). Assume the same facts as in example (1) except that the account receivable for $500 is paid on January 1, 1977. The account receivable for $500 will still be considered to relate to the taxable year (1975) in which the transaction occurred which gave rise thereto. However, such account receivable will be treated as an asset which is not a qualified export asset under § 1.993-2(d)(3) for the last day of such year.

Treas. Reg. § 1.993-4: Definition of producer's loans

(a) General rule—(1) Definition. Under section 993 (d), a loan made by a DISC to a person, referred to in this section as the "borrower", is a producer's loan if—

(i) The loan is made out of accumulated DISC income within the meaning of subparagraph (3) of this paragraph.

(ii) The loan is evidenced by an obligation described in subparagraph (4) of this paragraph,

(iii) The requirement as to the trade or business of the borrower described in subparagraph (5) of this paragraph is satisfied,

(iv) At the time the loan is made, the obligation referred to in subdivision (ii) of this subparagraph bears a legend stating "THIS OBLIGATION IS DESIGNATED A PRODUCER'S LOAN WITHIN THE MEANING OF SECTION 993(d) OF THE INTERNAL REVENUE CODE" or words of substantially the same meaning.

(v) The limitation as to the export-related assets of the borrower described in paragraph (b) of this section is satisfied,

(vi) The requirement as to the increased investment of the borrower in export-related assets described in paragraph (c) of this section is satisfied, and

(vii) The requirement of paragraph (d) of this section as to proof of compliance with paragraphs (b) and (c) of this section is satisfied.

(2) Application of this section—(i) In general. A loan which is a producer's loan is a qualified export asset of the DISC (see § 1.993-2(a)(5) and (f)). The interest on a producer's loan is a qualified export receipt of the DISC (see § 1.993-1(g)). A producer's loan is not a dividend to a borrower which is also a shareholder of the DISC making the loan. For rules with respect to deemed distributions by reason of the amount of foreign investment attributable to producer's loans, see section 995(b)(1)(G) and (d) and the regulations thereunder.

(ii) No tracing of loan proceeds. For purposes of applying this section, in order to qualify as a producer's

loan, the proceeds of the loan need not be traced to an investment in any specific asset.

(iii) Unrelated borrower. For purposes of applying this section, it is not necessary for a borrower to be a related person with respect to the DISC from which it receives a producer's loan, or a member of the same controlled group as the DISC.

(iv) Unpaid balance of producer's loans. For purposes of applying this section, the unpaid balance of producer's loans does not include the unpaid balance of any producer's loan to the extent the loan has been deducted or charged off by the DISC as totally or partially worthless under section 165 or 166.

(v) Refinancing, renewal, and extension. For purposes of applying this section, the refinancing, renewal, or extension of a producer's loan shall be treated as the making of a new loan which may qualify as a producer's loan only if the requirements of subparagraph (1) of this paragraph are met.

(vi) Events subsequent to time loan is made. The determination as to whether a loan qualifies as a producer's loan is made on the basis of the relevant facts taken into account for purposes of determining whether the loan was a producer's loan when made. Thus, for example, if the accumulated DISC income of the lender is later reduced below the unpaid balance of all producer's loans previously made by the DISC, such subsequent decrease in the amount of accumulated DISC income will not result in later disqualification of such loan (or part thereof) as a producer's loan. Similarly, if a loan (or part of a loan) does not qualify as a producer's loan because of an insufficient amount of accumulated DISC income at the time the loan is made, a subsequent increase in the amount of accumulated DISC income will not result in later qualification of such loan (or part thereof) as a producer's loan.[1] As a further example,

for purposes of applying the borrower's export related assets limitation described in paragraph (b) of this section, a loan which qualifies as a producer's loan when made will not later be disqualified if property, the gross receipts from the sale or lease of which were includible in the numerator of the fraction described in paragraph (b)(3)(i) of this section at the time of sale or lease by the borrower, is later characterized as excluded property (as defined in § 1.933-3(f)).

(vii) Application of tests under paragraphs (b) and (c) on controlled group bases. If the borrower is a member of a controlled group (as defined in § 1.933-1(k)) at the time a loan is made, all amounts that must be determined for purposes of applying the limitation and increased investment requirement with respect to the export-related assets of the borrower (described in paragraphs (b) and (c), respectively, of this section) may be determined at the election of the borrower by aggregating such amounts for all members of the controlled group, determined for the taxable year of each member of the controlled group during which the loan is made, excluding only such members of the group as are DISC's or foreign corporations for such year. However, such amounts may be included only to the extent that such amounts have not already been taken into account in applying the limitation and increased investment requirement with respect to any other borrower. The borrower may make such election by causing its written statement of election to be attached to the lending DISC's return under section 6011(e)(2) for the first taxable year of the lending DISC within which or with which the borrower's taxable year for which the election is to apply ends. An election once made is binding on all members of the controlled group which includes the borrower with respect to all taxable years of the borrower beginning with its first taxable year for which the election is made. A borrower who makes such election may revoke it only if it secures the consent of the Commissioner to such

revocation upon application made through the lending DISC.

(3) Loan out of accumulated DISC income—(i) In general. A loan is a producer's loan only to the extent that it is made out of accumulated DISC income. A loan is made out of accumulated DISC income only if the amount of the loan, when added to the unpaid balance at the time such loan is made of all other producer's loans made by a DISC, does not exceed the amount of accumulated DISC income of the DISC at the beginning of the month in which the loan is made. The amount of accumulated DISC income at the beginning of any month is determined as if the DISC's taxable year closed at the end of the immediately preceding month.

(ii) Presumption. A loan made during a taxable year shall be deemed under subdivision (i) of this subparagraph to have been made of accumulated DISC income if the balance of producer's loans at the beginning of the year and those made during the year do not exceed accumulated income at the end of the year.

(iii) Deemed distributions. For purposes of this subparagraph, accumulated DISC income as of the end of any taxable year (or month) shall be determined without regard to deemed distributions under section 995 (b)(1)(G) for the amount of foreign investment attributable to producer's loans for such year (or for the taxable year for which such month is a part) but actual distributions shall be taken into account.

(4) Evidence and terms of obligation. A loan is a producer's loan only if the loan is evidenced by a note or other evidence of indebtedness which is made by the borrower and which has a stated maturity date not more than 5 years from the date the loan is made. Accordingly, a loan which does not have a stated maturity date or which has a stated maturity date more than 5 years from the date such loan is made can never meet the 5-

year requirement of this subparagraph. Thus, for example, even if there is a period of less than 5 years remaining to the stated maturity date of a loan, the loan can never be a producer's loan if it had a stated maturity date more than 5 years from the date it was made. For a further example, if a loan having a period remaining to maturity of 2 years is extended for a further period of 3 years (making a total of 5 years to maturity from the date of the extension), the extension of the loan would under subparagraph (2)(v) of this paragraph constitute the making of a new producer's loan and the original producer's loan would terminate. If, however, a loan having a period remaining to maturity of 2 years is extended for a further period of 4 years (making a total of 6 years to maturity from the date of the extension), the original producer's loan will terminate and the new loan will not be a producer's loan. If a producer's loan is not paid in full at its maturity date and is not formally refinanced, renewed, or extended, such loan shall be deemed to be a new loan which does not have a stated maturity date and, thus, will not be a producer's loan. For purposes of this subparagraph, an evidence of indebtedness is a written instrument of indebtedness. Section 482 and the regulations thereunder are applicable to determine, in the case of a loan by the DISC to a borrower which is owned or controlled directly or indirectly by the same interests as the DISC within the meaning of section 482, whether the interest charged on such loan is at an arm's length rate.[2]

(5) Borrower's trade or business. A loan is a producer's loan only if the loan is made to a person engaged in the United States in the manufacture, production, growth, or extraction (within the meaning of § 1.993-3 (c)) of export property determined without regard to § 1.993-3(f)(1)(iii) and (iv). The borrower may also be engaged in other trades or businesses and the loan need not be traceable to specific investments in export property.

(b) Borrower's export related assets limitation—(1) General rule. A loan to a borrower is a producer's loan only to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower which are outstanding at the time the loan is made, does not exceed an amount equal to the amount of the borrower's export-related assets (determined under subparagraph (2) of this paragraph) multiplied by the fraction set forth in subparagraph (3) of this paragraph.

(2) Amount of export-related assets—(i) In general, For purposes of subparagraph (1) of this paragraph, the amount of the borrower's export-related assets is the sum of the amounts described in subdivisions (ii), (iii), and (iv) of this subparagraph.

(ii) Borrower's plant and equipment. The amount described in this subdivision is the sum of the borrower's adjusted bases (determined as of the beginning of the borrower's taxable year in which a loan is made to it) for plant, machinery, equipment, and supporting production facilities, which are located in the United States. Supporting production facilities are all property used primarily in connection with the manufacture, production, growth, or extraction (within the meaning of § 1.993-3(c)) or storage, handling, transportation, or assembly of property by the borrower.

(iii) Borrower's property held primarily for sale or lease. The amount described in this subdivision is the amount of the borrower's property (at the beginning of the taxable year of the borrower in which a loan is made to it) held primarily for sale or lease to customers in the ordinary course of its trade or business. The amount of such property held for sale is determined under the methods of identifying and valuing inventory normally used by the borrower. The amount of such property held for lease or leased is the borrower's adjusted basis, determined under section 1011, for such property.

(iv) Borrower's research and experimental expenditures. The amount described in this subdivision is the aggregate amount, whether or not charged to capital account, of research and experimental expenditures (within the meaning of section 174) incurred in the United States by the borrower during each of its taxable years which begin after December 31, 1971, and precede the taxable year in which the loan is made to the borrower. Such research and experimental expenditures need bear no relationship to export property (as defined in § 1.993-3) of the borrower. The aggregate amount of all such expenditures for each of such preceding taxable years is taken into account for purposes of this subparagraph, regardless of whether all or any portion of the aggregate amount has been taken into account with respect to producer's loans made to the borrower by any DISC in preceding taxable years. The aggregate amount of all such expenditures shall include such expenditures of a corporation, the assests of which were acquired by the borrower in a distribution or a transfer described in section 381(a)(1) or (2) (relating to carryovers in certain corporate acquisitions).

(3) Fraction referred to in sub-paragraph (1) of this paragraph—(i) Numerator of fraction. The numerator of the fraction set forth in this subparagraph is the sum of the borrower's gross receipts for each of its 3 taxable years immediately preceding the taxable year in which the loan is made (but not including any taxable year beginning before January 1, 1972) from the sale or lease of export property *(determined without regard to § 1.993-3(f)(1)(iii) and(iv))* which is manufactured, produced, grown, or extracted (within the meaning of § 1.993-3(c)) by the borrower whether or not sold or leased directly or through a related[3] *domestic* person (notwithstanding § 1.993-3(a)(4)[4] and (f)(2)). For purposes of the preceding sentence, with respect to a sale or lease to a related DISC in which the transfer price is determined under section 994(a)(1) or (2), the rules

under § 1.994-1(c)(5)(relating to incomplete transaction) shall be applied, and with respect to all other sales and leases the rules under § 1.994-1(c)(5) other than subdivision (i)(d) thereof shall be applied.

(ii) Denominator of fraction. The denominator of the fraction set forth in this subparagraph is the sum of the amount included in the numerator and all other gross receipts of the borrower, for each of its taxable years for which gross receipts are included in the numerator of the fraction, from all sales or leases of all property held by the borrower primarily for sale or lease to customers in the ordinary course of its trade or business. For purposes of subdivision (i) of this subparagraph and this subdivision, if such property is sold or leased to a domestic related person which resells or subleases such property, the borrower's gross receipts shall be the gross receipts derived by the domestic related person from the resale or sublease of the export property.

(iii) Taxable years. If the borrower has not engaged in the sale or lease of property (as described in this subparagraph) for the 3 immediately preceding taxable years, or if 3 taxable years beginning after December 31, 1971, have not elapsed, the fraction will be computed on the basis of such gross receipts for its taxable years immediately preceding the loan and beginning after December 31, 1971, during which the borrower has so engaged. No producer's loans can be made to a borrower until after the end of the first taxable year of the borrower beginning after December 31, 1971.

(c) Requirement for increased investment in export-related assets—(1) In general. A loan to a borrower is a producer's loan only to the extent that the amount of the loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower during the borrower's taxable year during which such loan is made, does not exceed the amount of the borrower's increase for the year in investment in export-related

assets. Such increase for any taxable year is the sum of—

(i) The increase (if any) in the borrower's adjusted basis of certain types of assets as determined under subparagraph (2) of this paragraph and

(ii) The amount (if any) during the year of its research and experimental expenditures as determined under paragraph (b)(2)(iv) of this section.

(2) Increase in adjusted basis. The amount under this subparagraph is the amount (not less than zero) by which—

(i) The borrower's adjusted basis (determined as of the end of its taxable year in which the producer's loan is made) in all of its property which is described in paragraph (b)(2)(ii) (plant and equipment) and (iii) (property held primarily for sale or lease) of this section, including any such property acquired by it during such taxable year, exceeds

(ii) Its adjusted bases in all such property (determined as of the beginning of such year).

(3) Ordering rule. If during the borrower's taxable year the amount of increase in investment in export-related assets determined under this subparagraph is exceeded by amounts loaned to the borrower during such year that would otherwise qualify as producer's loans, such loans shall be applied in the order made against the amount of such increase in order to determine which loans qualify as producer's loans.

(d) Proof of borrower's compliance with paragraphs (b) and (c) of this section. For purposes of paragraphs (b) and (c) of this section, a DISC shall be prepared to establish initially the compliance of the borrower with the requirements of such paragraphs by providing the written statement of the borrower, certified by a certified public accountant, stating that the borrower has com-

plied with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954. In lieu of certification by a certified public accountant, the DISC may attach to its return a statement signed by the borrower under penalties of perjury on a form provided by the Internal Revenue Service certifying that the borrower has complied with the limitation and increased investment requirement in section 993(d)(2) and (3) of the Internal Revenue Code of 1954. For taxable years ending after October 17, 1977 the DISC must attach either the certification by the certified public accountant or the certification by the borrower to its return. Additional full substantiation of the borrower's compliance with the requirements of such paragraphs may be required by the district operator. If full substantiation of such compliance is not provided by the DISC (or the borrower) when required the loan shall be deemed not to be a producer's loan.

(e) Special limitation in the case of domestic film maker—(1) General rule. The limitation of paragraph (b) of this section as to the export-related assets of the borrower will be considered satisfied if the DISC—

(i) Is engaged in the trade or business of selling or leasing films which are export property, or is acting as a commission agent for a person who is so engaged.

(ii) Makes a loan to a borrower which is a domestic film maker (as defined in subparagraph (5) of this paragraph) for the purpose of making a film, and

(iii) The amount of such loan, when added to the unpaid balance of all other producer's loans made by all DISC's to the borrower which are outstanding at the time the loan is made, does not exceed an amount determined by multiplying—

(a) The sum of (1) the amount of the export-related assets of the borrower (determined under paragraph (b)(2)(i) of this section as of the beginning of the borrower's taxable year in which the loan is made), plus

(2) the amount of a reasonable estimate of the amount of such export-related assets obtained or to be obtained by the borrower during such year and subsequent years with respect to films as to which filming begins within such year by

(b) The percentage which, based on the experience of other film makers of similar films for the 5 calendar years preceding the calendar year in which the loan is made, the annual gross receipts (as described in § 1.993-6(a)(1), whether or not such films constitute property described therein) of such other film makers from the sale or lease of such films outside the United States is of the annual gross receipts of such other film makers from all sales or leases of such films.

(2) Purpose of loan. A loan by a DISC will be deemed to be for the making of a film if there exists a written agreement between the DISC and the borrower, executed at or before the time the loan is made, stating that the loan is made or to be made to enable the borrower to make such film.

(3) Reasonable estimate of amounts. For purposes of subparagraph (1)(iii)(a)(2) of this paragraph, a reasonable estimate shall be based on the conditions known by the DISC and borrower to exist at the time a loan is made (or which the DISC and borrower have reason to know to exist at such time).

(4) Experience of film makers. For purposes of subparagraph (1)(iii)(b) of this paragraph, the experience of other film makers of similar films for the 5 calendar years preceding the calendar year in which the loan is made shall be derived from such records and statistics as are acknowledged in the trade as reasonably reliable.

(5) Domestic film maker. For purposes of this section, a borrower is a domestic film maker with respect to a film if—

(i) The borrower is a United States person within the meaning of section 7701(a)(30), except that (a)

with respect to a partnership all of the partners must be United States persons and (b) with respect to a corporation all of its officers and at least a majority of its directors must be United States persons.

(ii) The borrower is engaged in the trade or business of making the film with respect to which the loan is made.

(iii) Each studio, if any, used or to be used for filming or for recording sound incorporated into such film is located in the United States (as defined in section 770 (a) (9)).

(iv) At least 80 percent of the aggregate playing time of the film is or will be photographed within the United States (as defined in section 7701(a) (9)), and

(v) At least 80 percent of the total amount (not including any amount which is contingent upon receipts or profits of such film and which is fully taxable by the United States) paid or to be paid for services performed in the making of the film is either paid or to be paid to persons who are United States persons at the time such services are performed or consists of amounts which are fully taxable by the United States.

(6) Amounts as fully taxable. For purposes of subparagraph (5) (v) of this paragraph, an amount is considered fully taxable by the United States if the entire amount is included in gross income under section 61 or is subject to withholding under any provision of United States law or treaty to which the United States is a party and is not exempt from taxation under any provision of such law or treaty. Where a nonresident alien individual is engaged for the making of a film or where a foreign corporation is engaged to furnish the services of one of its officers or employees for the making of a film, the amount paid such individual or corporation will be considered as fully taxable by the United States only if it meets the test of this subparagraph.

85-879

No. ———

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

THOMAS INTERNATIONAL LIMITED,
Petitioner

v.

THE UNITED STATES,
Respondent

SUPPLEMENTAL APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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BEST AVAILABLE COPY

IN THE UNITED STATES CLAIMS COURT

No. 449-81T

THOMAS INTERNATIONAL LIMITED

v.

THE UNITED STATES

I.R.C. §§ 991-97 Domestic International Sales Corporation (DISC); Commissions Receivable from a related supplier as qualified export assets; Authority of Commissioner to issue regulations under I.R.C. § 7805; Treas. Reg. § 1.993-(2)(d)(2) invalid as not authorized by statute.

(Filed October 12, 1984)

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Mary M. Abate, Washington, D.C., with whom was *Assistant Attorney General Glenn L. Archer, Jr.*, for defendant. *Theodore D. Peyser*, of counsel.

OPINION

ON CROSS-MOTIONS FOR SUMMARY JUDGMENT

MILLER, *Judge*:

This suit is for refund of corporate income taxes paid for the years 1977 and 1978.

Internal Revenue Code (I.R.C.) §§ 991-97 provides for deferred tax treatment of income from foreign sales conducted through an intermediary corporation known as a Domestic International Sales Corporation, or DISC. I.R.C. § 992(a) provides, *inter alia*, that for a corporation to be a DISC it must own qualified export assets, the adjusted basis of which at the close of its taxable year equals or exceeds 95 percent of the sum of the adjusted basis of all of its assets; and § 993(b) provides that qualified export assets include accounts receivable. The question at issue is whether or not the Treasury is authorized to provide by regulation that an account receivable representing accrued commissions payable to the DISC by its related supplier in connection with the sale of export property is includible in qualified export assets only if such commissions are paid no later than 60 days after the close of the taxable year.

Facts

Plaintiff, Thomas International Limited (hereinafter TIL), is a wholly owned corporate subsidiary of Thomas Built Buses (hereinafter TBB). TBB is engaged in the business of manufacturing and selling buses. TIL was organized by TBB in 1973 to qualify as a DISC, and TIL elected such treatment from and after its first taxable year. During the taxable years at issue, TIL engaged exclusively in export related activities.

On July 1, 1973, TIL and TBB executed a written supplier's agreement whereby TIL would serve as a "commission DISC" in conformity with the Internal Revenue Code and Treasury Regulations. As a commission DISC, plaintiff accrued a commission from TBB on all export sales made by TBB. The amount of the commission was determined under the "50-50 combined taxable income method (described in § 994(a)(2), discussed *infra*).

For the taxable years ending March 31, 1977 and 1978, TBB reported sales of export property yielding taxable

income of $1,416,462 and $658,114, respectively. TIL accumulated entitlement to gross commissions with respect to these export sales, of $708,231 in 1977, and $329,057 in 1978. These commissions were properly accrued as accounts receivable in the books of TIL on March 31, 1977 and 1978, respectively. However, TBB did not actually pay such commissions to TIL until December 15, 1977, and June 1, 1978, respectively.

Plaintiff reported on its federal income tax returns DISC taxable income of $665,737 for its taxable year ended March 31, 1977, and $307,640 for its taxable year ended March 31, 1978. However, because of its claim to qualification as a DISC, it paid no taxes for either year.

On January 9, 1981, the Internal Revenue Service (I.R.S.) issued notices of deficiencies to TIL stating its determiation that TIL did not qualify as a DISC for the taxable years ending in 1977 and 1978, because, at the end of these taxable years, the adjusted basis of the qualified export assets owned by TIL did not equal or exceed 95 percent of the sum of the adjusted basis of all assets held by TIL, as required by § 992(a)(1)(B). The reason underlying the determination was that the commissions receivable by plaintiff from TBB for 1977 were not paid to it until 8½ months after the close of that taxable year and for 1978 until 62 days after the close of that year.

Plaintiff paid the assessed deficiency and filed claims for refund. On April 3, 1981, the I.R.S. disallowed TIL's claims and plaintiff timely filed this suit on July 20, 1981.

The General DISC Statutory Scheme

The DISC provisions, I.R.C. §§ 991-97, were originally added to the Code by the Revenue Act of 1971 (Pub. L. No. 92-178, Title V, § 501, 85 Stat. 535). The purpose of the legislation was explained as follows:

> [I]t is important to provide tax incentives for U.S. firms to increase their exports. This is important not

> only because of its stimulative effect but also to remove a present disadvantage of U.S. companies engaged in export activities through domestic corporations. Presently, they are treated less favorably than those which manufacture abroad through the use of foreign subsidiary corporations. United States corporations engaging in export activities are taxed currently on their foreign earnings at the full U.S. corporate income tax rate regardless of whether these earnings are kept abroad or repatriated. In contrast, U.S. corporations which produce and sell abroad through foreign subsidiaries generally can postpone payment of U.S. tax on these foreign earnings so long as they are kept abroad.
>
> In addition, other major trading nations encourage foreign trade by domestic producers in one form or another. * * * Both to provide an inducement for increasing exports and as a means of removing discrimination against those who export through U.S. corporations, your committee's bill provides a deferral of tax where corporations meeting certain conditions—called Domestic International Sales Corporations—are used.

(H.R. Rep. No. 533, 92d Cong., 1st Sess. 58 (1971), *reprinted in* 1972-1 C.B. 498, 529; and *see also* S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971), *reprinted in* 1972-1 C.B. 559, 609.)

In general, the profits of a DISC are not taxed to the DISC, but, prior to enactment of the Deficit Reduction Act of 1984 [1] were to be taxed to its corporate shareholder when distributed or deemed distributed. I.R.C. § 991. The DISC is not required to have any employees or payroll. Its orders may be solicited by the parent corporation's sales force, in the parent's name, and collections

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[1] Act of July 18, 1984, § 805(b)(2)(A), Pub. L. No. 98-369, 98 Stat. 494, 1001 (to be codified at 26 U.S.C. § 991 note).

may also be handled directly by the parent. The parent may impute to the DISC either the proceeds of the export sales or commissions on such sales. I.R.C. § 994 (b)(1); Treas. Reg. § 1.993-1(1) (1977). As the court stated in *Caterpillar Tractor Co. v. United States*, 218 Ct. Cl. 517, 525-26, 589 F.2d 1040, 1044 (1978):

> a DISC is permitted to be no more than a shell corporation with no employees, the only purpose of which is to act as an accounting vehicle for the earnings of its affiliated or parent corporation * * * which is designed to permit the deferral of a portion of an enterprise's profits from the exportation of products as long as the DISC is in existence.

I.R.C. § 992 prescribes the statutory qualifications for a DISC, included among which are that 95 percent or more of the DISC's gross receipts must consist of qualified export receipts, and that at the close of its taxable year the adjusted basis of the corporation's qualified export assets must equal or exceed 95 percent of the adjusted basis of all of its assets.

I.R.C. § 993 provides the definitions for qualified export receipts and qualified export assets. Insofar as pertinent, qualified export receipts are those from the sale of export property and for services related and subsidiary to any qualified export property for ultimate use outside the United States. I.R.C. § 993(a). Likewise, insofar as pertinent, qualified export assets refers generally to property produced in the United States for sale or rental in the ordinary course of business outside the United States. I.R.C. § 993(b). In the case of commissions on the sale of property, the amount taken into account as gross receipts are the gross receipts on the sale or rental of the property on which the commissions arose. I.R.C. § 993(f).

I.R.C. § 994, entitled "Inter-company Pricing Rules", prescribes the standard for the allocation of income between the related corporations. Under § 994(a) the tax-

able income of the DISC is to be based on a transfer price from the shareholder-supplier which would allow the DISC to derive income from the sale of the property in an amount which does not exceed the greater of: (1) 4 percent of the qualified export receipts on the sale of the property by the DISC plus 10 percent of the export promotional expenses attributable to the DISC; (2) 50 percent of the combined taxable income of the DISC and the supplier plus 10 percent of the DISC's attributable export promotional expenses; or (3) income based upon the sale price actually charged by the supplier to the DISC (but subject to adjustment pursuant to § 482).

I.R.C. § 994(b) also directs the Secretary of the Treasury to prescribe regulations setting forth "rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals and other income." Pursuant to this authority, in Treas. Reg. § 1.994-1(d)(2), the Secretary has prescribed that if any transaction to which I.R.C. § 994 applies is handled on a commission basis for a related supplier by a DISC and such commissions give rise to qualified export receipts, the amount of the income which may be allocated as earned by the DISC is the amount which under § 994(a) the DISC would have been permitted to earn if the related supplier had sold the property to the DISC and the DISC in turn had sold it to a third party.

I.R.C. § 995, which deals with "Taxation of DISC Income to Shareholders", prescribes the portion of the DISC income which is initially taxable to its shareholders each year and the applicable conditions and times when the remainder of the DISC income becomes taxable to them either because it is actually distributed or it is deemed distributed whether or not it is actually done.

Discussion

Pursuant to the regulatory authority set forth in § 994(b), Treas. Reg. § 1.994-1 implements the provisions

of I.R.C. § 994 for allocating income between DISC and related supplier as follows:

> § 994. *Inter-company pricing rules*
>
> * * * *
>
> (e) Method of applying paragraphs (c) [Transfer price for sale of export property] and (d) [Rules under section 994(a)(1) and (2) for transactions other than sales] of this section—
>
> * * * *
>
> (3) Initial payment of transfer price or commission. (i) The amount of a transfer price (or reasonable estimate thereof) actually charged by a related supplier to a DISC, or a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related supplier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transactions occurred.

Although neither I.R.C. § 992(a)(1) (which requires that the adjusted basis of the qualified export assets at the close of the year equal or exceed 95 percent of the total asset basis) nor § 993(b) (which defines "qualified export assets" to include, *inter alia*, "accounts receivable * * * which arise by reason of transactions of such corporation") contains authority similar to that in § 994 for the issuance of regulations, nevertheless the Secretary has prescribed regulations under § 993 that trade receivables representing commissions due from unrelated principals may be treated as qualified export assets but that those due from related suppliers are not to be so treated unless paid within 60 days after the close of the year, to wit (Treas. Reg. § 1.993-2(d)):

> (2) Trade receivables representing commissions. If a DISC acts as commission agent for a principal

> in a transaction described in § 1.993-1(b), (c), (d), (e), (h), or (i) which results in qualified export receipts for the DISC, and if an account receivable or evidence of indebtedness held by the DISC and representing the commission payable to the DISC as a result of the transaction arises * * * such account receivable or evidence of indebtedness shall be treated as a trade receivable. *If, however, the principal is a related supplier* (as defined in § 1.994-1(a)(3)) *with respect to the DISC, such account receivable or evidence of indebtedness will not be treated as a trade receivable unless it is payable and paid in a time and manner which satisfy the requirements of § 1.994-1(c)(3)* * * *. (Emphasis added.)

Plaintiff claims that the § 1.993-2(d)(2) regulatory exclusion from qualified assets at the close of the year of an account receivable representing commissions due from a related supplier merely because they were paid more than 60 days after the close of the year is unauthorized, arbitrary, legislative in character and contrary to the DISC statute.

Defendant relies wholly upon the reasoning of the Tax Court in *CWT Farms v. Commissioner*, 79 T.C. 1054 (1982) (*appeal docketed*, No. 84-8012 (11th Cir. Jan. 4, 1984)[2] to sustain the validity of the regulation. There the court found authority for the regulation in I.R.C. § 7805(a) which generally authorizes the Secretary of the Treasury to "prescribe all needful rules and regulations for the enforcement of" the revenue statutes. It noted that the inquiry of the courts is "generally limited to the question whether the regulation implements the congressional mandate in some reasonable manner * * *,

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[2] Also followed in *Fritzche Dodge & Olcott, Inc. v. Commissioner*, 45 T.C.M. 607 (1983) and *LeCroy Research Systems Corp. v. Commissioner*, 47 T.C.M. 1345 (1984), *appeal docketed*, No. 84-4062 (2d Cir. Apr. 25, 1984).

or in other words, whether the challenged regulation harmonizes with the plain language of the statute, its origin, and purpose." *CWT Farms*, 79 T.C. at 1061-62.

It held the challenged regulation to be a permissible interpretation of the language of § 993(b)(3) because it found such language to be "anything but unambiguous." *Id.* at 1063.

Section 993(b)(3) provides in pertinent part that—

> the qualified export assets of a corporation are—
>
> * * * *
>
> (3) accounts receivable * * * which arise by reason of transactions of such corporation * * * described in subparagraph (A), (B), (C), (D), (G) or (H), of subsection (a)(1).

The transactions referred to in subparagraph (A) are "the sale, exchange, or other disposition of export property."

The Tax Court thought that since the qualified accounts receivable are those "which arise by reason of transactions [sales] of such corporation [the DISC]", and a commission DISC has no sales of its own the "accounts receivable" in question is susceptible of an interpretation excluding those of a commission agent. Hence, the Tax Court reasoned, "the extent to which Congress intended commissions receivable owed by the producer to the related DISC to constitute qualified export assets is unclear * * * [and] the challenged regulation can in no way be said to contradict or limit the 'unambiguous' language of section 993(b)(3)."

However, in the light of the entire statute this court finds the alleged ambiguity to be more apparent than real. That Congress intended to allow a DISC to operate as a commission agent as well as a reseller of goods and services is implicit in § 993(f), which defines the term

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In the Supreme Court of the United States

OCTOBER TERM, 1985

THOMAS INTERNATIONAL LIMITED, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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In the Supreme Court of the United States

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No. 85-879

THOMAS INTERNATIONAL LIMITED, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner challenges the court of appeals' holding that it failed to qualify as a domestic international sales corporation (DISC) for the tax years at issue because of noncompliance with applicable Treasury Regulations. The decision below is correct. Petitioner does not allege, nor is there, a conflict among the circuits on the question presented. The question has little prospective importance, since the DISC provisions have been superseded for tax years after 1984. The case warrants no further review.

1. Thomas Built Buses, Inc. (TBB) manufactures buses for sale in domestic and export markets. Petitioner was organized in 1973 as a wholly-owned subsidiary of TBB to serve as a commission agent for TBB's export sales (Pet. App. SA2). Petitioner was created in order to take

advantage of the tax benefits provided for DISCs by Sections 991 through 997 of the Internal Revenue Code.[1]

Congress enacted the DISC provisions to encourage exports of domestic products. S. Rep. 92-437, 92d Cong., 1st Sess. 6-7, 90 (1971). Although Congress conferred substantial tax benefits on DISCs, it established numerous and stringent requirements that a corporation must meet to qualify. The statutory requirement relevant here is set forth in Section 992(a)(1)(B). That Section provides that a corporation can qualify as a DISC only if "the adjusted basis of [its] qualified export assets * * * at the close of the taxable year equals or exceeds 95 percent of the sum of the adjusted basis of all [its] assets * * * at the close of the taxable year." This requirement is designed to ensure that the tax-deferral benefit of the DISC provisions is available only with respect to earnings that are reinvested in the export business.

"Qualified export assets" are defined to include "producer's loans" and certain "accounts receivable" held by a DISC (I.R.C. § 993(b)(3) and (5)). Generally speaking, a "producer's loan" is a species of loan made by a DISC to its parent or to another related party; a debt obligation must satisfy exhaustive statutory criteria to qualify as a "producer's loan." See I.R.C. § 993(d). The Treasury Regulations provide that "accounts receivable" generally include "trade receivables." Treas. Reg. § 1.993-2(d)(1). The Regulations further provide, however, that trade receivables representing unpaid export commissions owed to a DISC by its parent, or by another related party, constitute "qualified export assets" only if they are "paid no later than 60 days following the close of the taxable year of the DISC

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[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended, as in effect for the tax years in issue (the Code or I.R.C.).

during which the transaction occurred." Treas. Reg. § 1.994-1(e)(3); see Treas. Reg. § 1.993-2(d)(2). By requiring prompt payment of export commissions, the Regulations are designed to prevent a DISC from lending money to related parties for indefinite periods of time by deferring collection of such amounts, and thus circumventing the rigorous limitations that Congress placed on "producer's loans."

For its fiscal tax years ending March 31, 1977, and March 31, 1978, petitioner earned commissions from TBB in the respective amounts of $708,231 and $329,057 on export sales of TBB's buses. Petitioner did not receive payment from TBB for these commissions, however, until December 15, 1977 (in the case of the fiscal 1977 commissions) and June 1, 1978 (in the case of the fiscal 1978 commissions). The accrued commissions were thus paid 8½ months after the close of petitioner's 1977 tax year, and 62 days after the close of its 1978 tax year, respectively. See Pet. App. 4a, SA2-SA3.

On audit, the IRS determined that petitioner's accrued export commissions were not "qualified export assets" because TBB did not pay them off within 60 days after the close of petitioner's tax years, as the Regulations require. That determination caused petitioner to fail the "95% qualified export assets test" for each year, with the result that petitioner did not fulfill the statutory criteria for DISC status. See Pet. App. 4a-5a, SA3. The Commissioner asserted deficiencies in tax flowing from petitioner's failure to qualify as a DISC for 1977-1978.

Petitioner paid the deficiencies and, following the denial of its administrative claim for refund, filed this refund suit in the Claims Court. That court granted summary judgment for petitioner (Pet. App. SA1-SA15). It held that the Regulations' 60-day payment rule for accrued export commissions was invalid, stating that the rule "impose[d] an

additional arbitrary requirement not found in or authorized by any statutory provision" (*id.* at SA13 (footnote omitted)).

The court of appeals unanimously reversed (Pet. App. 1a-11a). It rejected petitioner's argument that the 60-day payment rule was inconsistent with the statute, an argument based on the theory that the statutory term "accounts receivable" (I.R.C. 993(b)(3)) necessarily included *all* export commissions receivable, regardless of when paid. "The term 'accounts receivable,' " the court of appeals said, "ordinarily connotes amounts due in return for goods or services supplied. A commission paid in return for selling activities, either a fixed amount or a percentage of the sales price, normally would not be described as an account receivable" (Pet. App. 7a). Since the term "accounts receivable" thus did not "unambiguously include" all species of unpaid export commissions, the court held that the Commissioner "had leeway to define and apply the statutory term so as properly and effectively to implement the congressional plan and purpose" (*id.* at 8a).

The court further concluded that the 60-day payment rule was "harmonious with the origin and purpose of the DISC legislation," since it ensured that taxpayers could not use export commissions as "a means of evading the strict requirements and limitations Congress placed upon producer loans" (Pet. App. 8a-9a (quotation marks omitted)). The producer-loan restrictions, the court noted, "were designed to insure that a producer would not divert the tax-immunized DISC funds into non-export activities" (*id.* at 9a). The 60-day payment rule for export commissions furthered this legislative objective since, "[u]nless promptly paid, commissions due a DISC from its parent [would] in effect create an open line of credit, upon which the parent [could] draw at will for whatever purposes it wishe[d]"

(*ibid.*). The court also rejected petitioner's alternative contention that TBB's belated payment of the export commissions achieved "substantial compliance" with the 60-day payment rule, holding that literal compliance with the Regulations was required and that petitioner in any event "d[id] not establish substantial compliance" (*id.* at 11a).

2. The decision below is correct. This Court has repeatedly held that courts "must defer to Treasury Regulations that 'implement the congressional mandate in some reasonable manner' " and that such Regulations " 'must be sustained unless * * * plainly inconsistent with the revenue statutes.' " *Commissioner* v. *Portland Cement Co.*, 450 U.S. 156, 169 (1981) (quoting *United States* v. *Correll*, 389 U.S. 299, 307 (1967), and *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948)). Accord, *e.g.*, *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476-477 (1979). The court of appeals correctly held that the challenged Regulations offer a reasonable interpretation of the statutory phrase "accounts receivable," particularly when that term is considered in light of the overall statutory scheme and Congress's purpose in enacting the DISC provisions. As petitioner concedes (Pet. 6-9), the decision below accords with the decisions of every other court of appeals that has considered the validity of the Regulations' 60-day payment rule. Those courts have held, consistently with the decision below, both that the 60-day payment rule is valid and that taxpayers must achieve literal (and not merely "substantial") compliance with the DISC regulatory framework. See *LeCroy Research Systems Corp.* v. *Commissioner*, 751 F.2d 123, 125-126 (2d Cir. 1984); *CWT Farms, Inc.* v. *Commissioner*, 755 F.2d 790, 796-797, 799-802 (11th Cir. 1985), aff'g 79 T.C. 1054 (1982), petition for cert. pending, No. 84-1966.[2]

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[2]The pending petition in *CWT Farms* presents an additional question not presented by the instant case, viz., whether the Commissioner

Petitioner's contention that the decision below "conflicts with certain decisions of this Court concerning the scope of the Treasury's authority in promulgating interpretative regulations" (Pet. 6) is wholly insubstantial. The standard of review employed by the court of appeals in assessing the Regulations' validity is precisely the standard that petitioner states to be correct under this Court's decisions. Compare Pet. App. 6a-7a with Pet. 6. What petitioner disagrees with is not the Federal Circuit's view of the scope of the Treasury's rulemaking authority, but the Federal Circuit's conclusion that the challenged Regulations are not "plainly inconsistent" with the statute under which they were promulgated (*Commissioner* v. *South Texas Lumber Co.*, 333 U.S. at 501). See Pet. 8-9. Petitioner's disagreement, in other words, is with the court of appeals' conclusion that these particular Regulations are valid, a conclusion as to which there is no conflict whatsoever, either among the circuits or with any decision of this Court.

Finally, there is no merit to petitioner's assertion (Pet. 9-14) that the question presented has sufficient importance to warrant certiorari in the absence of a conflict. As we noted in our brief opposing certiorari in *CWT Farms* (84-1966 Br. in Opp. at 10), the question of the validity of the 60-day payment rule has little prospective importance. The

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abused his discretion (see I.R.C. § 7805(b)) in giving retroactive effect to the challenged Regulations. See 84-1966 Pet. at 9-11. While the courts of appeals have unanimously upheld the validity of these Regulations, the Second and Eleventh Circuits, as we noted in our brief opposing certiorari in *CWT Farms* (84-1966 Br. in Opp. at 10-11), have disagreed as to the propriety of applying them retroactively. Since Treas. Reg. § 1.994-1(e)(3), setting forth the 60-day payment rule, was adopted in final form on September 29, 1976 (41 Fed. Reg. 43141), the question of retroactive application is not presented in this case, which involves petitioner's DISC status for its fiscal years ending March 31, 1977, and March 31, 1978. (We are sending a copy of our brief in *CWT Farms* to petitioner's counsel.)

DISC provisions as a whole have been superseded for tax years after 1984. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 801, 98 Stat. 985 (enacting I.R.C. §§ 921-927) (replacing DISC system with system of foreign sales corporations (FSCs)).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

JANUARY 1986

DOJ-1986-01

"gross receipts" to include the gross receipts on the sale or rent of property even where the DISC receives only commissions on the sale by the supplier, and in § 994(b), which authorizes the Secretary to prescribe rules for the allocation of income between DISC and supplier "in the case of commissions." If a commission DISC, which ordinarily could not be expected to have substantial tangible assets, were required to exclude its commissions receivable from qualified export assets while including them in total accrued assets, it is problematical how many, if any, of such agents could qualify as DISCs under the 95 percent qualified export assets test. To avoid disqualification of commission DISCs "accounts receivable * * * which arise by reason of transaction of such corporation [the DISC]" must necessarily be understood to include sales in which the DISC is assigned by the producer the role of commission agent rather than reseller.

Finally, even if there were an ambiguity with respect to whether or not the accounts receivable which arise by reason of sales transactions of the DISC include those sales in which the DISC is merely the agent, it has been resolved by provisions of Treas. Reg. § 1.993-2(d)(2) other than the 60-day payment requirement. The regulation unconditionally includes in accounts receivable which arise by reason of transactions of the DISC commissions receivable from any producer other than a related one no matter when paid. It also includes commissions receivable from a related supplier if paid within 60 days after the close of the year. The requirement that the commissions receivable from the latter be collected within the 60 days may not reasonably be deemed to be merely an interpretation of any statutory phrase but is an additional requirement superimposed thereon for another purpose.

In a second prong of its reasoning the Tax Court came to grips with such other purpose. It held that the valid-

ity of the 60-day payment provision of § 1.992-2(d)(2) may be sustained as a reasonable means of preventing the use of uncollected commissions receivable as a device to frustrate the "producer's loan" provisions of the legislation, which restrict the uses for which a DISC may lend its tax-free funds to an export producer while continuing to treat the obligation as a qualified export asset of the DISC. *CWT Farms*, 79 T.C. at 1066-67. Section 993(d) provides that such a loan must be evidenced by an instrument with a stated maturity of not more than 5 years; it may only be made to a person engaged in the United States in the manufacturing, production, growing or extraction of export property; it must be designated as a producer's loan when made; it is limited by a formula to the amount of the borrower's export related assets; and it is further limited to the extent that the borrower increases its investment in export related inventory and plant plus research and experimental expenditures during the year. The court stated that if the regulation cannot be justified under the grant of regulatory authority in § 994(b) it can again be justified under the general authority of § 7805 as a reasonable interpretation of § 993 dealing with what constitute qualified export assets.

It must be concluded that this justification for the regulation at issue is likewise not sustainable as an interpretation of any statutory language. It is an effort to close a loophole by adding a requirement to the statute which Congress failed to adopt.

As a general matter the regulations of an administrative agency charged with the duty to carry out a congressional mandate are entitled to great weight; but this general principle of deference only sets the framework for judicial analysis and does not displace it. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982). It is hornbook law that the Treasury has no power to promulgate a regulation which either adds an exception

to or supplies an omission in a statute which it believes Congress should have included but did not. *Commissioner v. Acker*, 361 U.S. 87 (1959); *Helvering v. Credit Alliance Corp.*, 316 U.S. 107, 113 (1942); *Caterpillar Tractor Co.*, 218 Ct. Cl. at 526, 589 F.2d at 1045; *Durbin Paper Stock Co. v. Commissioner*, 80 T.C. 252, 261 (1983).

In some instances Congress has delegated to the Treasury authority to adopt legislative or rule-making regulations with appropriate standards necessary to the administration and enforcement of broad statutes with varieties of applications and opportunities for tax avoidance which Congress could not reasonably anticipate upon enactment. *See e.g.*, I.R.C. §§ 453 (relating to accounting for income on installment sales), 611(a) (allowing a reasonable allowance for depletion), and 1502 (relating to consolidated returns). And such regulations have been upheld as having the force of law. *Commissioner v. South Texas Lumber*, 333 U.S. 496, 503 (1948); *Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 169 (1981); *American Standard, Inc. v. United States*, 220 Ct. Cl. 411, 416-17, 602 F.2d 256, 260 (1979); *Garvey v. United States*, 1 Cl. Ct. 108, 113 (1983). *aff'd*, 726 F.2d 1569 (Fed. Cir. 1984), *cert. denied*, 53 U.S.L.W. 3232 (U.S. Oct. 2, 1984) (No. 83-1855). But § 7805 has been held not to be a source of delegation of such legislative authority. *Vogel Fertilizer Co.*, 455 U.S. at 24; *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981).

The vice in defendant's adoption of the regulatory requirement that payment of commissions receivable is to be made within 60 days of the close of the year on pain of rejection of the account as a qualified export asset is that it attempts to resolve a question of substance versus form by making conclusive against the taxpayer what would otherwise be only a single factor in that factual inquiry. It denies the taxpayer the opportunity to prove that the funds which could have been used to pay the

commissions were in fact used by the related supplier as export assets for purposes consistent with those permissible for producer's loans. And it also makes irrelevant any proof that the failure of the agent to receive payment of the commissions within the 60 days may have been for bona fide reasons, such as hardship, inadvertence, failure of the customer to make prompt payment, uncertainty as to account or difficulty in computation, rather than as a device to circumvent the producer's loan restrictions. In so doing it imposes an additional arbitrary requirement not found in or authorized by any statutory provision.[3]

In other instances where Congress has concluded that actual payment within a limited period after the close of the taxable year should be a proper test of the bona fides of accruals of claimed obligations for expenses owed to related taxpayers, it has not deemed the general authorization to the Secretary of the Treasury to adopt needful regulations sufficient to allow him to disallow such obligations. It has reserved for itself the express delineation of the kinds of expenses which may be disallowed, the number of days in which payment must be made, and the nature of the pertinent relationship between the taxpayers. I.R.C. § 267 disallows deductions, which would otherwise be allowable, for the amounts of accrued trade or business expenses (under § 162), for interest (under § 163), and for expenses for the production of income or conservation of property held for the production of income (under § 212), which are not includible in the income of the related taxpayer unless received, if they are not paid within 2½ months of the close of the taxpayer's taxable year. At the least, it would be anomalous

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[3] The fact that defendant concedes that, if the challenged regulation is invalid, it has no other defense on the merits also tends to support the inference that the regulation is arbitrary as applied to the plaintiff's circumstances in this case.

to conclude that Congress authorized the Treasury in its discretion to disallow an obligation as lacking in bona fides if the taxpayer did not pay it within 60 days after the close of the taxable year, while Congress itself thought a taxpayer should have 2½ months to make payment of an accrued obligation to a related taxpayer before it is deemed not bona fide.

Defendant seeks to draw some inference favorable to the validity of the challenged regulation from the fact that plaintiff does not contest the validity of Treas. Reg. § 1.994-1(e)(3)(i), which, *for purposes of the intercompany pricing rules*, provides that "[t]he amount of a transfer price (or reasonable estimate thereof) actually charged by a related supplier to a DISC, or a sales commission (or reasonable estimate thereof) actually charged by a DISC to a related supplier, in a transaction to which section 994 applies must be paid no later than 60 days following the close of the taxable year of the DISC during which the transactions occurred". But there are significant differences between § 1.994-1(e)(3)(i) and § 1.993-2(d)(2). I.R.C. § 994(b) directs the Secretary to prescribe rules for the application of that section in the case of commissions, rentals and other income, whereas neither I.R.C. §§ 992 nor 993, which set forth the prerequisites for qualification as a DISC has any comparable direction or authorization. Moreover, the consequence of a violation of § 1.994-1(e)(3)(i), which deals with failure to pay the purchase price, as well as commissions, within 60 days, may be far less severe. It results only in a change in the allocation of the income; whereas violation of § 1.993-2(d)(2), by failure to pay commissions within the 60 days, causes disallowance of the account payable as a qualified export asset and may result in the complete termination of DISC qualification and taxation of its entire accumulated income to its shareholder in a single year. *See* I.R.C. § 995(b)(2).

In any event, it is unnecessary to decide at this time whether or not § 1.994.1(e)(3) is valid, since it is sufficient for purposes of the instant case that adoption of the portion of that regulation dealing with commissions, to disqualify a corporation as a DISC under the § 992 test, is in itself unauthorized.

CONCLUSION

Defendant conceded in its brief and on oral argument that if Treas. Reg. § 1.993-2(d)(2) is not dispositive of plaintiff's complaint it has no other defense on the merits. Since it is determined herein that the regulation is invalid, the pleadings and admissions on file indicate that there is no genuine issue of material fact and that plaintiff is entitled to judgment as a matter of law.

The pleadings indicate that, as a result of the Commissioner's deficiency assessment attributable to the issue decided herein, for the year 1977 plaintiff overpaid $312,803 and for 1978 $140,917 in taxes, together with assessed interest of $123,053.16, and that payment of the $576,773.16 total was made on March 8, 1981. Plaintiff is entitled to refund of this sum with interest from March 9, 1981, as provided by law, and the clerk is directed to enter judgment accordingly.

/s/ Philip R. Miller
PHILIP R. MILLER
Judge

IN THE UNITED STATES CLAIMS COURT

No. 449-81 T

THOMAS INTERNATIONAL LIMITED

v.

THE UNITED STATES

[Filed Oct. 12, 1984]

JUDGMENT

Pursuant to the opinion of October 12, 1984, it was held that plaintiff is entitled to recover.

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiff recover of and from the United States the sum of $576,773.16, plus interest from March 8, 1981, as provided by law.

FRANK T. PEARTREE
Clerk of Court

By: /s/ Debra L. Samlet
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see FRAP 4(a)

SA-17

IN THE UNITED STATES CLAIMS COURT

No. 449-81T

THOMAS INTERNATIONAL LIMITED

v.

THE UNITED STATES

(Filed October 15, 1984)

ERRATA

Please make the following correction in the Opinion on Cross-motions for Summary Judgment filed October 12, 1984, in the above case:

Page 10, second complete paragraph, line 3 from the bottom of the page, the word "account" should be "amount".

/s/ Philip R. Miller
PHILIP R. MILLER
Judge

Supreme Court, U.S.
FILED
FEB 21 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-879

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

THOMAS INTERNATIONAL LIMITED,
Petitioner,

v.

THE UNITED STATES,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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PETITIONER'S REPLY TO MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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February 21, 1986

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

REVISED LIST OF AFFILIATED COMPANIES

Thomas Built Buses L.P., a Delaware limited partnership, sole shareholder of Thomas International Limited.

Thomas Built Buses, Inc., a North Carolina corporation, General Partner of Thomas Built Buses L.P. (and formerly the sole shareholder of Thomas International Limited).

Thomas Built Buses International, a Virgin Islands corporation controlled by Thomas Built Buses L.P.

Carrocerias Ecuatorianas Thomas, S.A., an Ecuadorian corporation controlled by Thomas Built Buses L.P.

Ricaseneth, an Ecuadorian corporation controlled by Thomas Built Buses L.P.

Thomas-Built Buses of Canada Limited, a Canadian corporation controlled by Thomas Built Buses L.P.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

No. 85-879

THOMAS INTERNATIONAL LIMITED,
Petitioner,

v.

THE UNITED STATES,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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PETITIONER'S REPLY TO MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Respondent's Memorandum in Opposition emphasizes that the questions presented have little prospective importance because of the repeal of the Domestic International Sales Corporation ("DISC") provisions of Internal Revenue Code ("Code") Sections 991 through 997 with respect to tax years after 1984. The repeal of the DISC provisions did not, however, vitiate the significance of the narrow question of the validity of Treas. Reg. § 1.993-2 (d) (2) (the "993 Regulation") to the many taxpayers who have brought (and are bringing) actions with respect to tax years that remain open and in which the issue has arisen. *E.g., CWT Farms, Inc. v. Commissioner*, 754 F.2d 790 (11th Cir. 1985), *petition for cert. pending*, No. 84-1966; *Gehl Co. v. Commissioner*, 49 T.C.M. (CCH) 372 (1984), *appeal docketed*, No. 85-1326 (7th Cir. Feb. 25, 1985). Because the rules that govern the phasing out of the DISC provisions provide for the dis-

tribution of all accumulated DISC income through December 31, 1984 to a DISC's shareholders free of tax, the issue of DISC qualification remains critical to many taxpayers. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 801, 98 Stat. 985 (enacting Code Sections 921 through 927, which replace the DISC system with the system of foreign sales corporations). In addition, the broader question whether the analysis of the Circuit Courts of Appeal on the issue conflicts with decisions of this Court concerning the scope of the Treasury's authority in promulgating regulations under Code Section 7805(a) is appropriate for the reasons Petitioner has set forth in its Petition. Pet. 6-9.

Petitioner would also call the Court's attention to the severe consequences of termination of DISC qualification because of a failure to comply with the 60-day payment rule of the 993 Regulation. Termination of DISC qualification means that the DISC's entire accumulated income (and not simply the income for the years of disqualification) is taxed to its shareholder. As noted by the Claims Court, a violation of the 60-day payment rule in the context of Treas. Regs. § 1.994-1(e)(3)(i) results only in reallocation of the income between the DISC and its related supplier. Pet. App. SA14. It is anomalous that the consequence of violation of a legislative regulation should be less severe than the consequences for violation of an interpretive regulation.

In addition, Petitioner once again notes that the government's justification for the 993 Regulation—to prevent circumvention of the producer's loan requirements of Code Section 993(d)—has no vitality in the face of facts such as those of this case, in which the producer's loan requirements have not been violated. Pet. 12. Nor is the justification sustainable as an interpretation of any statutory language. Rather, "[i]t is an effort to close a loophole by adding a requirement to the statute which Congress failed to adopt." Pet. App. SA11.

For the reasons set forth above and the reasons set forth in Petitioner's Petition, it is respectfully submitted that the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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February 21, 1986